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# Access To Capital or Just More Blues? Issuer Decision-Making Post SEC Crowdfunding Regulation

Patricia Hureston Lee

*Saint Louis University School of Law*

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# Access To Capital or Just More Blues? Issuer Decision-Making Post SEC Crowdfunding Regulation

PATRICIA H. LEE<sup>1</sup>

## ABSTRACT

Crowdfunding is an alternative for Issuers seeking funds for their businesses. On October 2015, the Securities Exchange Commission (SEC) released final crowdfunding regulations that became effective May 2016<sup>2</sup> as a charge of the Jobs Act, Title III (the “Crowdfund Act”). Issuers can now secure crowdfunded investments without a securities registration.<sup>3</sup>

This article evaluates investment-based crowdfunding from the perspective of one group that has been neglected from the crowdfunding scholarship—Issuers that seek financing under this new framework. In *Section I*, the author summarizes the new crowdfund regulations, which create a new financing opportunity vastly different from previous types of debt, reward and gift crowdfunding. In *Section II*, the author sets forth a

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<sup>1</sup> \*The author is an Associate Professor, Saint Louis University School of Law, Legal Clinic Director and Faculty Supervisor, Entrepreneurship and Community Development Clinic. Former corporate counsel of a Dow 30 company; B.A. in Economics, Northwestern University, and J.D., Northwestern University Law; Licensed to practice law in MO, IL, DC and US. Supreme Court. I am very grateful for the insights and research assistance from my colleagues: Saint Louis University School of Law faculty, Chad Flanders, Constance Wagner, Miriam Cherry, Kelly Mulholland, Matthew Bodie, David Kullman, Lynn Hartke, Yvette Liebesman, Molly Wilson, Carol Needham, Henry Ordower, Ann Scarlett and Michael Korybut; The University of Tennessee Law School faculty, Joan Heminway, Transactions: Tennessee Journal of Business Law Editor, Lucas S. Smith and Staff; West Virginia University Law faculty, Jena Martin, William Rhee and Anne Lofaso; Harris Stowe State University business faculty, Darryl Lee; Research Assistants, Robert Mahon, Jevon Romeo, and Kelly Smallmon; and funding from The Public Hodges/Bloom Junior Faculty Summer Research Grant.

<sup>2</sup> Crowdfund Act, 17 C.F.R. pt. 200, 227, 232, 239, 240 and 249 (2016).

<sup>3</sup> Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112–106, 126 Stat. 306, 315–23 (2012); Securities Act of 1933, 48 Stat. 74, (codified as amended at 15 U.S.C. § 77a *et seq.*); Title III of the Jobs Act, Crowdfund Act, §§ 301–05. The acronym for the Crowdfund Act of 2012 is: “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012.” Title III of the Jobs Act added new Securities Act Section 4(a)(6), which provides an exemption from the registration requirements of Securities Act Section 5 for certain crowdfunding transactions.

hypothetical Issuer case scenario, of a manufacturing business seeking \$700,000 in investment financing for its business growth and hiring needs. This article does not focus on lifestyle and small startup decision-making in the context of investment crowdfunding, but rather focuses on higher-growth business, which is the target of the legislation. Additional research is suggested to address the small enterprise capacity needed to comply with the regulations, pay the costs and sustain the liability risk of an investment crowdfunding campaign. In *Section III*, the author details financing alternatives to raise money, compliance costs, flow-through costs from intermediaries and costs needed to limit liability stemming from the transaction. The author develops a rubric to compare and contrast the financing alternatives. Next in *Section IV*, the author illustrates how an Issuer might arrive at a decision, weighing the risks, rewards, pros and cons, for the best funding vehicle available. Last, in *Section V*, the author contends that financing through this crowdfunding platform will be one of the most expensive ways for an Issuer to obtain capital.

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### INTRODUCTION

For several years, scholars have raised concerns about the complexity and costliness of the Crowdfund Act,<sup>4</sup> predicting that investment-based crowdfunding will fail for a number of reasons, namely because “requirements...burden issuers and portal intermediaries with costly disclosure and certification requirements... [and] subjects them to antifraud provisions. . . .”<sup>5</sup> Other scholars have expressed concerns that fearful investors would avoid investing in companies that crowdfund for equity. “Due to the possibility of fraud, the crowdfunding market may become a ‘market of lemons’ for issuers unable to obtain other early-stage financing.”<sup>6</sup>

From an Issuer's perspective, these statements alone would not stop an Issuer from proceeding into an investment-based crowdfunding campaign. First, an Issuer would consider that they need to raise capital and compliance costs would merely be a function of doing business. Secondly, an Issuer may naively believe that they can successfully complete the compliance with assistance from counsel and accountants and get the deal done. Last, the idea of Investor loss is probably the last thing on the mind of an optimistic Issuer. However, what may sway an Issuer from utilizing this platform would be hard, cold facts, about the costs of the financing (i.e. crowdfunding transaction costs of 25% of the transaction

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4 Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. ONLINE 217, 251–55 (2015). The author sets forth six reasons she believes equity crowdfunding is doomed: a) Fraud will be rampant; b) Section 4(6) is too costly and burdensome on issuers and portals; c) Equity crowdfunding will be a market of lemons; d) Issuers will choose accredited equity crowdfunding under New Rule 506; e) Funders will not participate in future profits; and f) Financial services industry will avoid crowdfunded startups. *Id.*

5 *Id.* at 260–61.

6 *Id.* at 261.

vs. loan transaction costs of 15%) and the probability of liability (i.e. mistake or omission of a fact that potentially could ruin an otherwise healthy, going concern).

Scholars have evaluated the risks and rewards of crowdfunding from the perspective of investors and intermediaries, but have only peripherally considered whether crowdfunding would be good for the Issuers (namely, high growth-entrepreneurs, small businesses, the job creators) that the Act was designed to help. This article attempts to ground the conversation in the realities of entrepreneurship with the decisions that Issuers must confront as they seek financing for their businesses. The author contends that for the high-growth Issuers targeted by the legislation, crowdfunding is likely to be too expensive, too complex and have too great of liability risk to undertake, when the Issuer has other financing alternatives. To illustrate this assertion, the author reviews the Crowdfund Regulation's requirements and provides an Issuer case study to evaluate this important decision.

## I. CREATION OF THE CROWDFUND ACT AND REGULATIONS

It wasn't until the "19<sup>th</sup> century industrial revolution [that] banks became the main source of business financing."<sup>7</sup> Private equity and venture capital investing "reflects the marriage of the [two] traditions. . . [of] 'professional' merchant banking and 'amateur' venture investing by wealthy individuals and families."<sup>8</sup> Although crowdfunding networks have existed since as early as the 2000's in the U.S.,<sup>9</sup> U.S. businesses were

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7 JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 106.2, at 1–14 (2015).

8 *Id.* ¶ 106.3, at 1–15. Furthermore, private investment transactions operated alongside of the U.S. governmental approval and promotion of entrepreneurial, artistic and innovation, empowered early on by the framers of the U.S. Constitution, in Article I, Section 8, clause 8. Congress empowered patent rights, "To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right in their respective writings and discoveries."

9 Daniela Castrataro, *A Social History of Crowdfunding*, SOC. MEDIA WEEK (Dec. 12, 2011), <https://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/>.

Author references a successful crowdfunding effort by a British rock group named Marillion, who she claims "gathered \$60,000 in 1997 to finance their US tour using an Internet campaign, the "Tour Fund." See also Justin Kazmark, *Kickstarter Before Kickstarter*, KICKSTARTER, (July 13, 2013), <https://www.kickstarter.com/blog/kickstarter-before-kickstarter?ref=hello>. The author shares the story of Alexander Pope, an 18th century

restricted from making general solicitations to the public<sup>10</sup> of financial interests in either their convertible debt or equity without first registering with the SEC.

Although business, innovation and commerce have long been a part of the private enterprise system, that system has omitted widespread public participation in investment deals. Arguably, such failure to broaden participation by all parts of the economy may be one of the reasons that the American economic engine has faltered and not grown to its greatest potential.

#### *A. Title III - The Crowdfund Act*

The JOBS Act included Title III, which was designated with the acronym “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012” or the “Crowdfund Act.” The Crowdfund Act required the SEC to adopt rules for the federal regulation of securities crowdfunding in the United States,<sup>11</sup> and included significant policy

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author, who sought to raise funds to translate Homer’s *Iliad* from Greek to English in “exchange for a shout-out in the acknowledgements, an early edition of the book, and the delight of helping to bring a new creative work into the world, 750 subscribers pledged two gold guineas to support Pope’s effort before he put pen to paper.”

10 On August 29, 2012, the SEC approved proposed rule, pursuant to Section 201(a) of the JOBS Act, that amended Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933. Title II of the JOBS Act requires the SEC to revise Rules 506 and 144A to remove the ban on general solicitation and general advertising in certain situations. The original deadline for this rulemaking was July 4, 2012, but SEC Chairman Mary Schapiro announced on June 28, 2012 that the SEC would not meet this deadline. See Practical Law Corporate & Securities, JOBS Act: Regulation D and Rule 144A General Solicitation Summary (last updated Aug. 21, 2016). On July 2, 2012, the SEC scheduled an open meeting for August 22, 2012 to amend Rule 506 of Regulation D under the Securities Act and Rule 144A under the Securities Act, as mandated by Section 201(a) of the Jumpstart Our Business Startups Act. They sought to remove the ban on general solicitation and general advertising for offerings sold only to accredited investors and amend Rule 144A to permit offerings to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers. See Press Release, SEC, Sunshine Act Meeting (July 2, 2012), <http://www.sec.gov/news/openmeetings/2012/ssamtg082212.htm>.

11 ABA Business Law Section, Subcommittee on Annual Review, Committee on Federal Regulation of Securities, *Annual Review of Federal Securities Regulation* (2015), at 956. See also

provisions, exempting emerging-growth companies (“EGCs”) from the Securities laws. The Crowdfund Act essentially eases “the registration and reporting requirements, facilitat[es] the burdens of going and being public that have increased consistently since the adoption of the Sarbanes-Oxley Act in 2002[,] [and] ...promotes an ‘IPO on-ramp’ that had been a goal of the U.S. Treasury Department, the SEC and a cross-section of industry participants, for several years.”<sup>12</sup> Congress also authorized the SEC to implement regulations to protect investors from fraud and abuse and to create a process for which this virtual investing could take place.

Key provisions of the Crowdfund Act are as follows:

- 1) Section 4 of the Securities Act of 1933 is amended by adding at the end the following: (6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that – (A) the aggregate amount sold to all investors by the issuer ... is not more than \$1,000,000; (B) the aggregate amount sold to any investor by the issuer ... does not exceed – (i) the greater of \$2,000 or 5 % of the annual income or net worth of such investor,... if the net worth of the investor is less than \$100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000; (C) the transaction is conducted through a broker or funding portal that complies with the requirements of section 4A(a); and the issuer complies with section 4A(b).<sup>13</sup>
- 2) The Securities Act of 1933 is amended with the insertion after section 4, the following words:  
Requirements With Respect to Certain Small

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Crowdfund Act, *supra* note 2.

12 Marcus J. Williams et al., *Current SEC Guidance for “Emerging Growth Companies” Seeking to Take Advantage of JOBS Act*, Davis, Wright Tremaine L. Blog (May 30, 2012), <http://www.dwt.com/Current-SEC-Guidance-for-Emerging-Growth-Companies-Seeking-to-Take-Advantage-of-JOBS-Act-05-30-2012>.

13 Jumpstart Our Business Startups Act (JOBS Act), H.R. 3606 (Apr. 5, 2012), § 302(a).

Transactions.

- 3) The Requirements for small transactions include: Requirements for Intermediaries (Brokers and funding portals) to register with the SEC, applicable self-regulatory organizations, provide disclosures, ensure that each investors has been informed, answers questions regarding risk, illiquidity and such other matters as the SEC determines appropriate by rule.

Furthermore, the Act required Intermediaries, which included Broker Dealers and Funding Portals to take measures to reduce the risk of fraud with respect to such transactions, as well as make information available to the SEC and to investors pursuant to subsection (b).<sup>14</sup>

Considering the historical limitations of private sector investment, it would have been a surprise for a sitting President to *not* agree with Congress that a new law to address the deficiency of private resources in business investment might also stimulate jobs. Additionally, with larger industrial companies' decline, there was a growing recognition of the fact that emerging, startup, high high-growth small businesses are exceptionally important to the engine of the economy.<sup>15</sup> Leading up to the Crowdfund Act provisions, several important considerations were in play, including job creation,

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14 *Id.* at § 302(b).

15 Martha Mattare, Michael Monahan & Amit Shah, *Navigating Turbulent Times and Looking into the Future: What Do Micro- Entrepreneurs Have to Say?*, J. OF MARKETING DEV. & COMPETITIVENESS, 5(1) 2010, at 79 (A statewide survey of micro-businesses.); *see also*, Press Release, The White House Office of the Press Sec'y, President Obama To Sign Jumpstart Our Business Startups (JOBS) Act (Apr. 5, 2012) (on file with author). The author notes that nothing here diminishes the importance of lifestyle business and new startups, which are very important to the U.S. economy. *See Entrepreneurship Policy Digest: The Importance of Young Firms for Economic Growth*, EWING MARION KAUFFMAN FOUNDATION (September 14, 2015), [http://www.kauffman.org/~media/kauffman\\_org/resources/2014/entrepreneurship%20policy%20digest/september%202014/entrepreneurship\\_policy\\_digest\\_september2014.pdf](http://www.kauffman.org/~media/kauffman_org/resources/2014/entrepreneurship%20policy%20digest/september%202014/entrepreneurship_policy_digest_september2014.pdf). "New businesses account for nearly all net new job creation and almost 20 percent of gross job creation, whereas small businesses do not have a significant impact on job growth when age is accounted for. Companies less than one year old have created an average of 1.5 million jobs per year over the past three decades." *Id.*



deregulating public investment capital and dismay that the high growth industrial sector was in decline. The President explained that one of the JOBS Act's purposes was to increase capital available to entrepreneurs and small businesses.<sup>16</sup>

America's high-growth entrepreneurs and small businesses play a vital role in creating jobs and growing the economy.... I'm pleased Congress took bipartisan action to pass this bill. These proposals will help entrepreneurs raise the capital they need to put Americans back to work and create an economy that's built to last.

Congress, in collaboration with the Executive branch, had suggested the JOBS Act as a congressional effort to incentivize and stimulate high-growth entrepreneurs, whether through lending programs, tax credits, or rural and urban community development initiatives to solve the nation's woes.<sup>17</sup> If the JOBS Act could start to deregulate public investment capital, it then raises the age-old question of whether or not deregulation is a good idea.<sup>18</sup>

The JOBS Act included three capital-formation priorities that the President first raised in his September 2011 address to a Joint Session of Congress and outlined in more detail in his Startup America Legislative Agenda to Congress in January 2012.<sup>19</sup> It allowed "crowdfunding,"

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16 See Press Release, The White House Office of the Press Sec'y, *supra* note 15.

17 OFFICE OF MGMT. & BUDGET, SUPPORTING SMALL BUSINESSES AND CREATING JOBS (2013), <https://www.whitehouse.gov/omb/factsheet/supporting-small-businesses-and-creating-jobs>.

18 Thomas A. Martin, *The JOBS Act of 2012: Balancing Fundamental Securities Principals with the Demands of the Crowd*, SOCIAL SCIENCE RESEARCH NETWORK (Apr. 12, 2012), <http://ssrn.com/abstract=2040953> (last visited July 24, 2012).

19 The JOBS Act included goals to grow businesses' access to financing while maintaining investor protections in the following ways: (1) Allowing Small Businesses to Harness "Crowdfunding": The internet already has been a tool for fundraising from many thousands of donors. Subject to rulemaking by the U.S. Securities and Exchange Commission (SEC), startups and small businesses will be allowed to raise amounts under \$1,000,000 annually from many small-dollar investors through web-based platforms, thereby democratizing access to capital. Because the Senate acted on a bipartisan amendment, the bill includes key investor protections the President called for, including a requirement that all crowdfunding must occur through platforms that are registered with a self-regulatory organization and regulated by the SEC. In addition,

expanded “mini-public offerings,” and created an “IPO on-ramp” consistent with investor protections. The Act had seven titles, spanned twenty pages, and had twenty-five subpart sections divided into additional subparts. Despite its brevity, the provisions of JOBS Act amended major aspects of the federal securities laws and with the Crowdfund Act<sup>20</sup> exempted selected transactions for issuers to raise capital for amounts under \$1,000,000. Last, there was a charge to the SEC. After changing some existing limitations on how companies can solicit private investments from “accredited investors,” the JOBS Act tasked the SEC with ensuring those companies take reasonable steps to verify that such investors are accredited, and gave companies more flexibility to plan their access to public markets and incentivize employees.

The impetus for the Crowdfund Act occurred in March 2012.

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investors’ annual combined investments in crowdfunded securities will be limited based on an income and net worth test. (2) Expanding Mini Public Offerings: Prior to this legislation, the existing “Regulation A” exemption from certain SEC requirements for small businesses seeking to raise less than \$5 million in a public offering was seldom used. The JOBS Act raises this threshold to \$50 million, streamlining the process for smaller innovative companies to raise capital consistent with investor protections. (3) Creating an IPO On-Ramp: The JOBS Act made it easier for young, high-growth firms to go public by providing an incubator period for a new class of “ECGs.” During this period, qualifying companies will have time to reach compliance with certain public company disclosure and auditing requirements after their initial public offering (IPO). Any firm that goes public already has up to two years after its IPO to comply with certain Sarbanes-Oxley auditing requirements. The JOBS Act extends that period to a maximum of five years (or less if during the on-ramp period a company achieves \$1 billion in gross revenue, \$700 million in public float, or issues more than \$1 billion in non-convertible debt in the previous three years). *See* Address By the President To A Joint Session of Congress, (Sep. 8, 2011), <https://www.whitehouse.gov/the-press-office/2011/09/08/address-president-joint-session-congress>; *See also* Startup America Legislative Agenda, (Jan. 2012), [https://www.whitehouse.gov/sites/default/files/uploads/startup\\_america\\_legislative\\_agenda.pdf](https://www.whitehouse.gov/sites/default/files/uploads/startup_america_legislative_agenda.pdf). Author elaborated on these two sources.

20 *See* The Crowdfund Act, *supra* note 2; *see also* LEVIN, *supra* note 7, at 2-58 to 2-59 on the limitations that existed pre-JOBS Act on resales of securities, “Without a ... SEC registration in a § 4(2) private placement, a Reg. D offering (other than in limited circumstances pursuant to Rule 504 as described in ¶207.3.1), or a Rule 701 sale are restricted securities for SEC purposes, the holder of an SEC restricted security can resell it only: In a subsequent private sale exempt from 1933 Act registration, or • In a public offering registered with SEC under the 1933 Act, or • In a public sale exempt from 1933 Act registration pursuant to SEC Rule 144, or • In a public sale pursuant to a Reg. A offering statement filed with SEC, or • In an “offshore transaction” in compliance with Reg. S with sales solely to persons not resident in the U.S., no “directed selling efforts” into the U.S. market with respect to such securities, and the securities restricted from resale to a U.S. resident for a specified period...”

During that time, several vocal venture capitalists expressed their concerns about the decline in venture-backed U.S. public offerings and the increase in companies being acquired by larger companies. First Round Capital Management's Director expressed concern that "[l]ast year, there were just 40 venture-backed U.S. companies [that] went public, compared to more than 460 that were acquired by larger companies,"<sup>21</sup> along with several other venture firm colleagues. "In a healthy market, [venture capitalists] would see 10 times the number of IPOs to acquisitions, not the other way around," they lamented.<sup>22</sup>

First, the November 2011 rate of unemployment hit a startling 8.7% of the labor force.<sup>23</sup> By the date of the signing of the JOBS Act, the unemployment rate had dropped slightly to 8.2%. Reporters weighed in on the troubling trends toward declining employment; such trends included teenage jobs on the decline, women's participation in the labor market on the decline, and baby boomers transitioning into retirement, thus creating far more jobless people in the U.S.<sup>24</sup> Compare that to the 2016 4.9% unemployment rate.<sup>25</sup>

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21 See Josh Kopelman et al., *The JOBS Act Can Rebalance Risks and Rewards for Emerging Growth Companies, Investors*, THE PE HUB NETWORK (Mar. 20, 2012), <https://www.pehub.com/2012/03/the-jobs-act-can-rebalance-risks-and-rewards-for-emerging-growth-companies-investors/>; (Josh Kopelman is a managing director of First Round Capital; Jason Mendelson is a managing director of Foundry Group; Jon Callaghan is a managing partner of True Ventures, and Jeff Clavier is managing partner of SoftTech VC); see also U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS (2012). The GAO study was required by Section 402 of the JOBS Act to describe factors affecting trends in securities offerings made in reliance on Regulation A under the Securities Act of 1933. Key findings of the study include: After peaking in 1998 (57 offerings), the number of completed Regulation A offerings has significantly declined to just one offering in 2011. While multiple factors contributed to this decline, a major factor was the increased attractiveness of Regulation D, which, unlike Regulation A, preempts state blue-sky laws. Stakeholders interviewed by the GAO had differing opinions on whether simply raising the \$5 million per issuer, per year limit for Regulation A offerings to \$50 million would increase its use.

22 *Id.*

23 *United States Unemployment Rate 1948 – 2013*, TRADING ECON. (Nov. 11, 2012), <http://www.tradingeconomics.com/united-states/unemployment-rate>.

24 Annalyn Censky, *America's Job Crisis – The 86 million invisible unemployed*, CNN MONEY (May 4, 2012, 10:39 AM), <http://money.cnn.com/2012/05/03/news/economy/unemployment-rate/>.

25 Heather Long, *Why Doesn't 4.9% Unemployment Feel Great?*, CNN MONEY (Feb. 6, 2016), <http://money.cnn.com/2016/02/06/news/economy/obama-us-jobs/> (visited on October 16, 2016).

Second, the U.S. gross domestic product (GDP) totaled \$15.094 trillion in 2011; of that number, private companies supplied 86.8% and the government supplied the other 13.2%.<sup>26</sup> Leigh Buchanan, Editor of *Inc. Magazine* and former Editor of *Harvard Business Review*, annually highlights the Inc. 500 (companies that are some of the fastest growing private companies in the United States) and broke some figures down even further. Buchanan explained that the greatest economic growth was in “companies five years old and younger” because they created “virtually all net job growth” and not large corporations.<sup>27</sup>

The statistics on this phenomenon and its potential for jobs was startling: In 2012, of *Inc.*’s “500 honorees, 488 companies added jobs between 2007 and 2010. Collectively, [these companies] *generated* 35,823 jobs over three years. The companies in the Fortune 500, by contrast, *eliminated* 821,000 jobs in 2009 alone, despite buoyant profits.”<sup>28</sup> In contrast, for the less selective *Inc.*’s 5000, the 5000 top private companies had revenues of less than \$1 billion annually.<sup>29</sup> However, only 51 companies had revenues from \$1 billion to \$40 billion.<sup>30</sup>

Economic researchers claimed that incremental growth in business could affect job creation and argued that good policy would support enterprises that produced jobs more rapidly.<sup>31</sup> This reasoning suggested a focus on growth-oriented companies partly because “America’s great challenge is to scale the successful ecosystems and to create others to bring about a substantial increase in the numbers of highly successful new companies (whether or not they reach a billion dollars in sales)” and of the rhetoric “[n]othing less than the future welfare of

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26 Donald D. Kim, Teresa L. Gilmore & William A. Jolliff, *Annual Industry Accounts: Advance Statistics on GDP by Industry for 2011*, U.S. BUREAU OF ECON. ANALYSIS (May 2012).

27 Leigh Buchanan, *Growth Is in Overdrive on This Year’s Inc. 500*, INC. MAG. (Sept. 2011), <http://www.inc.com/magazine/201109/inc-500-fastest-growing-private-companies.html>.

28 *Id.* (emphasis added).

29 Inc. 5000 Report, INC. MAG. (Sept. 2011), <http://www.inc.com/inc5000/search/2011/1000000000-40000000000/x/x/x/x/x/>.

30 *Id.*

31 Robert E. Litan, *Inventive Billion Dollar Firms: A Faster Way to Grow*, EWING MARION KAUFFMAN FOUND. (Dec. 2010).

America and its citizens is at stake.”<sup>32</sup>

Third, venture-backed capital financing to U.S. companies continued to decline, partially because of Sarbanes-Oxley and partially because of previous market boom/bust cycles and federal regulators were more willing to listen to the economic challenges.<sup>33</sup> Thus, in June 2011, the U.S. Department of Commerce explained the compounded problem for high-growth companies, including declining investments, typical challenges with operating capital, as well as legal and regulatory constraints. Commerce explained the financial investment decline as follows:

... in the wake of recent economic challenges, entrepreneurs in high-growth companies have found their access to capital significantly constrained. Investment in startup and early-stage companies has steadily declined since the dot-com crash, compounding the typical challenges high-growth startups face with operating capital. Concurrently, later-stage firms’ access to funds through the public markets has been curtailed due to the unintended consequences of legal and regulatory actions taken to protect investors and limit fraud such as the Spitzer Decree and the 2002 Sarbanes-Oxley Act. If America wants to maintain its global leadership in entrepreneurial talent, companies, and innovation, it must take steps to address these challenges, and reduce barriers limiting high-growth firms’ access to capital.<sup>34</sup>

At the same time, internet technology and social media have evolved to

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<sup>32</sup> *Id.*

<sup>33</sup> REPORT TO SEC’Y LOCKE, U.S. DEPT. OF COMMERCE, NAT’L ADVISORY COUNCIL ON INNOVATION AND ENTREPRENEURSHIP, IMPROVING ACCESS TO CAPITAL FOR HIGH-GROWTH COMPANIES (2011).

<sup>34</sup> *Id.*

accommodate crowdfunding investments, with scholars explaining that “the structure of the financial markets has changed as a result of electronic trading.”<sup>35</sup>

The Crowdfund Act was purportedly established to stimulate emerging company growth and create a framework for capital investments through early-stage crowdfunding. Early-stage crowdfunding allows entrepreneurs to use an internet-based “crowd” to fund their ventures.<sup>36</sup> This new framework allowed public investment by accredited and not accredited investors—a movement that would open up the marketplace to broader populations. The fundamental idea was that Issuers, namely entrepreneurs and innovators, would be “able to use the Internet to pitch business ideas to millions of potential investors”<sup>37</sup> whether those investors were accredited or unaccredited.

Investment-based crowdfunding is a variation from previous crowdfunding concepts. Generally, the term crowdfunding refers to the activity of raising small sums of money from a large number of individuals (the crowd) over the internet without registering the securities.<sup>38</sup> Raising money for equity is different from raising funds for a donation, a reward, or other thing. A security is defined under § 2(a)(1) of the Securities Act of 1933 and § 3(a) of the Securities Exchange Act of 1934 and it covers instruments such as securities, stocks, bonds, and unique or novel instruments.<sup>39</sup>

However, as scholars have illustrated, funding via the crowd to

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35 Karen Kunz & Jena Martin, *Into the Breech: The Increasing Gap between Algorithmic Trading and Securities Regulation*, 47 J. OF FIN. SERVS. & RES. 135, 142 (2015).

36 See Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd*, 29 J. OF BUS. VENTURING 585 (2014). The issue of regulatory capture is not addressed in this article. However, the parties that may reap significant advantage have been written in to the regulations, with the result of higher costs for entrepreneurs seeking capital.

37 Jeff Thomas, *Making Equity Crowdfunding Work for the Unaccredited Crowd*, 4 HARV. BUS. L. REV. ONLINE 62, 62 (2014).

38 Crowdfund Act, *supra* note 2.

39 DOUGLAS M. BRANSON ET AL., BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE AND POLICY, CASES, MATERIALS, AND PROBLEMS 213, (Matthew Bender, 2d ed. 2012).

accomplish Issuer capital-raising goals, can be of many varieties, including donation, reward, pre-purchase, lending and equity crowdfunding.<sup>40</sup> These type of reward, charitable, and pre-purchase crowdfunding types preceded the JOBS Act,<sup>41</sup> and have been successfully used by smaller entities for startup capital. Examples in reward crowdfunding are found on crowdfunding platforms such as Kickstarter,<sup>42</sup> Indiegogo<sup>43</sup> and Fundable,<sup>44</sup> whereby “...artists and entrepreneurs use the Internet to obtain financing from strangers to produce a creative or consumer product, such as a CD or a wristwatch, and the funders are later compensated with the product itself.”<sup>45</sup> The largest crowdfund platform in the rewards category is Indiegogo, which was founded by Danae Ringelmann, Eric Schell and Slava Rubin to address concerns about fundamental flaws in our financial system.<sup>46</sup> “For centuries, access to funding had been controlled by a select few,” so as a result, they developed a platform which democratized a way for small enterprises to raise funds for theatres and to help cure diseases such as Myeloma. This type of reward crowdfunding has helped fund startups, film, music projects, non-profits and other types of small business that otherwise would not have been able to arrange financing through friends, family,

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40 C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 30–42 (2012); see e.g., Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433 (2012); Joan MacLeod Heminway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011); MORRISON & FOERSTER, JOBS ACT QUICK START A BRIEF OVERVIEW OF THE JOBS ACT 2014 UPDATE 54 (2014); Andrew Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457 (2013).

41 Joan MacLeod Heminway, *What is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 358 (2012) (Author discusses models of crowdfunding and five funding models offered by Professor Steven Bradford including: 1. Donation; 2. Reward; 3. Pre-purchase; 4. Lending; and 5. Equity); see Bradford, *supra* note 40, at 14–27.

42 KICKSTARTER, <https://www.kickstarter.com> (last visited Oct. 1, 2016).

43 INDIEGOGO, <https://www.indiegogo.com> (last visited Oct. 1, 2016).

44 FUNDABLE, <https://www.fundable.com> (last visited Oct. 1, 2016).

45 Schwartz, *supra* note 40, at 1458; see STEVEN JOHNSON, FUTURE PERFECT: THE CASE FOR PROGRESS IN A NETWORKED AGE 35 (2012); see also Bradford, *supra* note 40, at 16–17.

46 *About Us*, INDIEGOGO, <https://www.indiegogo.com/about/our-story> (last visited Oct. 15, 2016).

folks, angels or venture capitalists.

On October 30, 2015, the SEC adopted Regulation Crowdfunding (Regulation CF),<sup>47</sup> the final rules for the implementation of a new framework for investment-based crowdfunding. The next section provides a summary of Regulation CF.

### *B. Regulation CF*

After almost two years of comments, the SEC adopted final rules in Regulation CF<sup>48</sup> on October 30, 2015, with an effective date of May 16, 2016. The final regulations adopted a number of comments and made improvements to the earlier proposed regulations that had been issued earlier in October 2013. The SEC reviewed and considered over 485 comment letters to its proposed rules.<sup>49</sup> In the final rules, the focus continued to be investor protection, issuer capital acquisition and intermediary/issuer compliance.

Regulation CF creates the rules for a new type of investment crowdfunding distinguishable from the previous crowdfunding models that traditionally allowed for a variety of types and forms of donation, reward-based and debt crowdfunding.<sup>50</sup> This new funding vehicle for startups would allow offerings of investments in convertible debt or equity with participation by non-accredited investors, the public, as well as investors who had been allowed before—accredited investors.

Although a robust crowdfunding market has developed and grown

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47 SEC Adopts Rules to Permit Crowdfunding, Press Release 2015-249 (Oct. 30, 2015), <https://www.sec.gov/news/pressrelease/2015-249.html>.

48 17 C.F.R. pt. 200, 227, 232, 239, 240 and 249 (2016).

49 ABA Business Law Section, *supra* note 11 at 956. Authors note that comments were received from professional trade associations, investor organizations, law firms, investment companies and investment advisers, broker-dealers, potential funding portals, members of Congress, the SEC's Investor Advisory Committee, state securities regulators, government agencies, potential issuers, accountants, and other interested parties. *See also* Comments on Proposed Rule: Crowdfunding, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/comments/s7-09-13/s70913.shtml> (last visited Oct. 15, 2016).

50 *See* Heminway, *supra* note 41, at 358.



rapidly over the past decade for donation/debt crowdfunding,<sup>51</sup> it is unknown what the true impact of investment crowdfunding will be. One can speculate about the impact of the new regulations by extrapolating the growth of traditional crowdfunding internet portals such as Kickstarter, LendingClub, and developing European Union portals (which ultimately may eclipse the portals developed in the United States);<sup>52</sup> however, doing so may be unwise. At the very least, the requirements, costs, burdens and benefits differ significantly between these earlier models and in light of the fact, that the new model involves the sale of an equity position in the company, we don't have the precedent of the liability that may flow from an Issuer or an Intermediary utilizing this alternative.

Although Regulation CF provides the rules for this form of crowdfund, at this point, we don't know whether there will be success in projects going forward. Ideally, success would look something like the Kickstarter or Indiegogo success trajectory, which provided opportunities for small enterprises to receive cash based on reward-, donation- and debt-based crowdfunding. Crowdfunding for donation-, reward- and debt-based fundraising has successfully produced funded outcomes for small enterprises. As an example, Kickstarter, has as its mission to help bring creative projects to life, and has grown from 3,910 successful projects in 2010, to 23,000 successful projects in 2012,<sup>53</sup> and 113,226 successful projects by 2016.<sup>54</sup> That is a 588% growth in successful projects in three years and a 2896% growth in six years. During this same period, amounts pledged increased respectively nearly tenfold in three years and to \$2.7 Billion in the six years following its formation. The graph below illustrates

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51 *Id.*

52 John Baptiste Su, *CEO Tech Talk: Lending Club Plans Expansion Into Car Loans, Mortgages*, FORBES (Apr. 1, 2015), <http://www.forbes.com/sites/jeanbaptiste/2015/04/01/exclusive-interview-lending-club-ceo-plans-expansion-into-car-loans-mortgages/#531b53c256f3>.

53 David Drake, *Crowdfunding Will Make 2013 The Year of the Gold Rush*, FORBES (Dec. 27, 2012), <http://www.forbes.com/sites/groupthink/2012/12/27/crowdfunding-will-make-2013-the-year-of-the-gold-rush/#171af0125c2a>.

54 See KICKSTARTER, <https://www.kickstarter.com/help/stats> (last visited on Oct. 1, 2016); see also Andrew Schwartz, Dana Brakman Reiser & Steve Dean's scholarship on other ways to measure success/non-success (other costs and benefits of crowdfunding) based on the type of security offered.

the growth on the crowdfunding site Kickstarter (Graph 1).

To the extent that investment-based crowdfunding sites can replicate this success, there will purportedly be winners from Regulation CF. This information has some limited value in that it illustrates the growth of past crowdfunding, as well as the variety and sizes of different sites.

**Graph 1: Illustration Kickstarter Projects and Success Chart, 2010-2016<sup>55</sup>**

2010	2011	2012	By Oct. 16, 2016
3,910 Successfully Funded Projects	11,836 Successfully Funded Projects	More than 23,000 Successfully Funded Projects	More than 113,226 Successfully Funded Projects
\$27,638,318 Pledged	\$99,344,381 Pledged	Over \$230 Million Pledged	\$2.7 Billion Pledged
43% Project Success	46% Project Success	44% Project Success	35.86% Project Success

**Graph 2: Total Amounts Raised through Crowdfunding Platforms from 2013-2015<sup>56</sup>**

	2013	2014	2015 (Projected)
Global Crowdfunding	\$6.1 B	\$16.2 B	\$34.4 B

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55 See David Drake, *supra* note 53. See also KICKSTARTER, *supra* note 54.

56 MASSOLUTION, 2015CF: THE CROWDFUNDING INDUSTRY REPORT (2015), <http://www.crowdsourcing.org/editorial/global-crowdfunding-market-to-reach-344b-in-2015-predicts-massolutions-2015cf-industry-report/45376>.

### Graph 3: Total Amounts Raised through Crowdfunding Platforms 2011<sup>57</sup>

2011	Description
\$1.5 Billion	US and Global (All types)
\$174 Million	Equity/Reward Based Only
68% larger	Size of Equity based deals on crowdfunding

The graphs illustrate that donation and debt crowdfunding deals are currently tenfold to the equity/reward-based crowdfunding. Part of the reason is that, currently, previous investment crowdfunding was principally available through an existing SEC registration/exemption. Now that Regulation CF rules have been adopted, it will take some time to determine the actual impact of the legislation.

Eagerness of the marketplace, with a plethora of internet sites readying themselves for new markets of Issuers, the public and money is another consideration for the potential growth of investment-based crowdfunding. For example, take a new site such as Money Crashers which currently lists the top 10 internet sites for equity crowdfunding, with the top five being AngelList, Circle Up, EquityNet, Crowdfunder and Fundable.<sup>58</sup>

On the other hand, one factor that may reduce the impact of Regulation CF is the predictable compliance costs and liabilities for Issuers. In Regulation CF, the SEC set forth commentary on predictable economic costs and benefits once the regulations become the law. As a red flag, the SEC suggested that there may be some impact due to these

<sup>57</sup> Regulation Crowdfund (2012), at 332–333.

<sup>58</sup> Brian Martucci, *Top 10 Equity Crowdfunding Sites for Investors and Entrepreneurs*, MONEY CRASHERS, <http://www.moneycrashers.com/equity-crowdfunding-sites-investors-entrepreneurs/> (last visited Oct. 1, 2016). The author includes top equity crowdfunding sites and also notes that “equity crowdfunding is a great way for entrepreneurs and small business owners to raise money. For investors, it offers the opportunity to support exciting concepts. However, equity crowdfunding is riskier than investing in established, publicly traded firms with marketable products, experienced leadership, and a history of profitability. Don’t invest any money you can’t afford to lose.” *Id.*

costs. This fact alone did not make them refrain from including requirements that keep the costs high. The sizable costs stem from the SEC's attempt to protect investors through required disclosures, licensing requirements, and other regulatory requirements. The costs are proportionate to the size of the transaction, and bear similarity to the cost structure for exempted filings that previously would have been completed under Rule 506 and other exemptions under the securities laws.

To the extent that donation- and debt-based crowdfunding has been so successful, does that mean investment-based crowdfunding will be as successful for Issuers that seek capital for their businesses? To answer that question, we first review the data provided by the SEC on the current status of all crowdfunding as of 2015 and then apply it to an Issuer case scenario. Crowdfunding would include donation-, debt-, and equity/reward-based crowdfunding in the US and globally. A research team from Massolution collected information on 1,250 active crowdfunding platforms (CFPs) across the world, including data submitted by 463 crowdfunding platforms to the Crowdfunding Industry Survey, to analyze the amounts raised through crowdfunding platforms.<sup>59</sup>

The charitable, rewards and pre-purchase types of crowdfunding follow a model that does not involve an investor's receipt of financial returns. That being the case, these types of crowdfunding would not raise securities law concerns in this country because what is being offered does not constitute a "security" as that term is defined under the federal securities laws.<sup>60</sup> According to case law, the Supreme Court has determined that stock as a security has several attributes, namely the right to receive dividends based upon profits, negotiability, a capacity to be pledged or hypothecated, voting rights proportional to share ownership,

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59 Lori Smith, Bridget Henwood & Michael Psathas, *Title III Securities-Based Crowdfunding: Ten Things You Should Know If You Are Considering Participating as an Issuer, Investor or Intermediary*, WHITE & WILLIAMS LLP (Nov. 19, 2015), <http://www.whiteandwilliams.com/resources-alerts-Title-III-Securities-Based-Crowdfunding-Ten-Things-You-Should-Know-if-You-Are-Considering-Participating-as-an-Issuer-Investor-or-Intermediary.html>.

60 A distinction is made when the goal is of a commercial nature and there is an opportunity for the participants to take part in the profits, the federal and state securities laws may apply. See MORRISON & FOERSTER, *supra* note 40, at 54.

and value that can appreciate.<sup>61</sup>

In contrast, investment-based crowdfunding would involve offering an individual or corporation an equity investment stake in the Issuer's business. While such crowdfunding has attracted a great deal of interest, it also presents regulatory issues. Since securities crowdfunding involves a promise of financial return and otherwise meets the definition of a "security" under the federal securities laws, a financing would not be legal unless the units offered are either registered with the SEC or exempt from registration. Prior to the Crowdfund Act, no such exemption was available. In 2012, however, Congress thought it would be a good idea to include that opportunity in the JOBS Act.

A new registration exemption for crowdfunded securities was carved into the 1933 Act as Section 4(a)(6). As could be expected, the entrepreneurial community felt joyful about this new act. At the same time, entrepreneurs seeking capital and counsel representing them began to decipher the requirements and found the imposition of a high level of costs on entrepreneurs and start-ups most inclined to use crowdfunding, and a puzzling array of disclosure requirements. The costs stem from the heavy regulatory burden imposed, including issuer disclosure requirements, entrepreneur's reporting requirements and the requirement that sales take place through a new SEC-registered framework called a funding portal. There is also an annual report that must be filed with the SEC and provided to investors. Both the issuer disclosure and reporting requirements require financial statements, either reviewed or audited by an independent public accountant, depending on the size of the offering.

In addition, there is a new liability provision in Section 4A(c) of the 1933 Act, creating a private right of action against entrepreneurs who make material misstatements or omissions in crowdfunding transactions. Unfortunately, this is hardly the type of registration exemption that small business was hoping for in the JOBS Act. Concerns remain whether the requirements undercut the very purpose of the JOBS Act—to make capital raising easier and cheaper for small business. It remains to be seen

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61 See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975); see also Joan MacLeod Heminway, *To Be Or Not To Be (A Security): Funding For-Profit Social Enterprises*, 25 REGENT U. L. REV. 299, 313–14 (2012-2013).

whether that will be the case.

The SEC was given the responsibility of drafting regulations to implement Title III, a process that took more than three years and resulted in a 685-page document. Unfortunately, given the mandate of the statute, the SEC did not have the option to lighten the burden for issuers. In essence, what Congress did in the legislation was “wrote a mini-registration law rather than authorizing the SEC to craft a crowdfunding exemption.”<sup>62</sup> I contend that the crowdfunding exemption will be one of the most expensive ways to raise money, in light of Issuer disclosure costs and other costs that will undoubtedly be imposed by intermediaries, flowing through to Issuers.

In October 2015, the SEC released the Regulation CF. Simply put, these regulations will, as of May 2016, allow entrepreneurs eligible under the regulations to raise amounts up to \$1,000,000 dollars every twelve months by issuing shares of stock or bonds to both accredited and unaccredited investors. Both academic commentators and members of the business community have previously noted the regulatory burden and the high costs associated with crowdfunding under the proposed rules and are reviewing the final rules for its impact on their constituents.

Several academics have begun to wrestle with the cost-benefits of equity crowdfunding,<sup>63</sup> but how Issuers will weigh this new crowdfunding framework has not been addressed. More empirical research should be done as time goes on. With usage, we will better understand the merits of this type of investment-based crowdfunding. As of now, there are many unanswered questions. First, as we begin to think about an Issuer who engages crowdfunding as a means to finance their business, we must first address the likelihood that the Issuer would be better off choosing an alternative means of financing. This article includes a hypothetical example

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62 William Carleton, *The Fault Lies Not in Our Agencies, But in Our Congresses*, COUNSELOR @ LAW (Jan. 22, 2014), <http://www.wac6.com/wac6/2014/01/the-fault-lies-not-in-our-agencies-but-in-our-congresses.html>.

63 Academics include Joan MacLeod Heminway and Christine Hurt wrestling with the cost-benefits of equity crowdfunding. See Cohn, *supra* note 40, at 1437. Author questions why a simple registration exemption for small offerings was not implemented, which would have lessened the burdens on Issuers.

of an entrepreneur in an emerging-growth business deciding whether to use investment-based crowdfunding to fund its capital financing needs or instead, resort to other available funding options. Under what circumstances would an Issuer choose investment-based crowdfunding rather than an alternative form of financing? At what point in business' life cycle would crowdfunding be of greatest interest? What are the specific challenges, costs and liability that Issuers face in complying with this new regulatory framework? Do costs outweigh the benefits? Last, what impact will an Issuer's decision-making have on potential investors? This article takes on these issues from an entrepreneur's perspective with a case study to ground the discussion.

## II. CASE STUDY OF AN ISSUER SEEKING CAPITAL

A chronic money problem for almost two-thirds of small businesses is an age-old issue, with one-fifth of small businesses reporting that cash flow is a continuing problem.<sup>64</sup> In 2012, the federal government took on addressing the problems faced by entrepreneurs in their capital needs. Several events provided the rationale for a federal solution to stimulate startups and initiate investments via funding portals: increased unemployment nationwide; economic research that clarified the types of businesses that actually created jobs in the U.S. versus globally; U.S. corporate venture backed-capital financing continued to decline, partially because of Sarbanes-Oxley and partially because of previous market boom/bust cycles; and internet technology/social media had evolved to accommodate crowdfunding investments. The following is a hypothetical manufacturing business that desires to raise \$700,000 of capital in order to expand its manufacturing plant, create jobs and train employees.

### *A. Emerging Growth Urban Manufacturer Case Study Introduction*

This article sets forth a hypothetical manufacturing business that has a desire to raise capital to expand its manufacturing plant, hire highly skilled consultants and more plant employees. This case study provides a scenario to analyze the pros and cons of the new crowdfunding regulations framework. Yet, the company is fictional and any names or descriptions

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64 JEROME KATZ & RICHARD P. GREEN II, ENTREPRENEURIAL SMALL BUSINESS 452–53 (2014); *see also* NAT'L FED'N OF INDEP. BUS., NATIONAL SMALL BUSINESS POLL: THE CASH FLOW PROBLEM (2001).

that resemble an existing company are merely coincidental.

Crowdfunding has been proclaimed as a possible solution to companies seeking to grow and create jobs. To determine whether it is a good idea for a company to use the new crowdfunding framework, the article provides a decision tree to work through the decision.

## Background

FGH Corporation is a privately owned food manufacturing company located in St. Louis, Missouri. Husband and wife, James and Emma Smith, proudly founded FGH in 2010 following a long career in the restaurant industry. Emma and James own ninety percent (90%) of the business; James' parents, Cecilia and Fred, own four percent (4%); their daughter, Jan, owns four percent (4%); and their best friend, Gerald, owns two percent (2%) of the company stock. The company has a capitalization of \$5,000,000 currently, and annual sales are growing at a rate of 25% year over year. Last year's sales were the largest ever, with FGH bringing in \$1.0 million dollars.

The founders decided to locate FGH Corporation within St. Louis County, midway between Lambert Airport and ground rail and shipping outlets, because of the excellent shipping options. They felt that the location positioned them well to further expand an export business.<sup>65</sup> FGH sells their bottled and boxed food products domestically within the United States and also exports products to several foreign countries, mainly located in the European Union. The company's products consist of a diverse line of brand-label sauces, seasonings and condiments for ethnic and target markets.

FGH Corporation currently has six employees—the two founders, their daughter, three factory employees and two part-time professionals. One part-time professional is a bookkeeper and the other is an attorney. Also, there are a host of contractors that provide services to

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65 St. Louis has a strong transportation network with Interstates, U.S. highways, Class I rail, Lambert Airport, Missouri and Mississippi River access and City of St. Louis Port Authority (northernmost ice-free Mississippi port). See *The St. Louis Region: Gateway to Business*, MISSOURI PARTNERSHIP, <http://www.missouripartnership.com/Sites-Incentives-Data/Regions/St-Louis-Region> (last visited on Oct. 1, 2015).



FGH, including maintenance staffing, temp administrative assistance and technology web/brand designers.

### **Opportunity**

In St. Louis County, food manufacturing is considered a top rising opportunity. The top opportunity is food manufacturing; the second is computer and electronic product manufacturing; and the third is electronic equipment, appliance and component manufacturing.<sup>66</sup> In light of decades in the food industry, including restaurant operations and local sales of prepared foods, James and Emma Smith decided to leverage their knowledge of food by using the ingredients of their recipes to bottle and box several of their sauces, seasonings and condiments for domestic and international exporting.

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66 Laura Pizzo, *Industry SWOT Analysis: How To Identify Your Region's Comparative Advantages, Weaknesses, and Emerging Industries*, EMSI (Dec. 17, 2015), <http://www.economicmodeling.com/2015/12/17/industry-swot-analysis-how-to-identify-your-regions-comparative-advantages-weaknesses-and-emerging-industries/>.

**Economic Statistics St. Louis and United States (Table 1)**

	<b>2009</b>	<b>2014-2015</b>
Manufacturing Employment	Declined 9,900 jobs from March 08-09	Added 3,300 new jobs in the County
Cost of Living in Missouri	4 <sup>th</sup> lowest cost of living	17 <sup>th</sup> lowest cost of living in the nation
# of Fortune 1000 largest US companies in St. Louis County	14 in 2009 <sup>67</sup>	19 in 2015 <sup>68</sup>
St. Louis County's state economic share	20.1%	19.1% in 2014
Population of St. Louis City	356,587	317,419
Population of St. Louis County	992,408	1,001,876
Population of United States	306.8 Million	321.4 Million
2015 Private Companies Largest Growth in St. Louis area	Inc. Magazine ranked St. Louis area as fastest	41 private companies in growing private companies <sup>69</sup>
Population of BRICS countries Brazil, Russia, China, India and South Africa	2.89 Billion in 2009 <sup>70</sup>	3.1 Billion in 2015 <sup>71</sup>
Population of European Union <sup>72</sup>	502.1 Million in 2009 <sup>73</sup>	508.2 Million in 2015 <sup>74</sup>

67 Companies, St. Louis Reg'l Chamber, see <http://www.stregionalchamber.com/regional-data/companies>(last accessed Oct. 1, 2016).

68 *Id.*

69 *Id.*

70 For 2009, the population breakdown was approximately: Brazil was 198.7 Million; Russia was 140.04 Million; India was 1.17 Billion; China was 1.34 Billion; and South Africa was 49 Million. See INDEXMUNDI, <http://www.indexmundi.com/g/g.aspx?v=21&c=rs&l=en> (last visited Mar. 10, 2016). These entries give 2009 population estimates from the US Bureau of the Census based on statistics from population censuses, vital statistics registration systems, or sample surveys pertaining to the recent past and on assumptions about future trends. The total population presents one overall measure of the potential impact of the country on the world and within its region.

71 For 2015, the breakdown of the populations was approximately: Brazil was 207.8 Million; Russia was 146.5 Million; India was 1.3 Billion; China was 1.38 Billion; and South Africa was 55 Million, for a total of 3.1 Billion.

72 The European Economic Union reached its current size of 28 member countries with the accession of Croatia on 1 July 2013. See EUROPEAN UNION, [http://europa.eu/about-eu/countries/member-countries/index\\_en.htm](http://europa.eu/about-eu/countries/member-countries/index_en.htm) (last visited Oct. 1, 2016).

73 See *Population on 1 January*, EUROSTAT, <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tps00001&plugin=1> (last visited Oct. 1, 2016).

74 *Id.*

## **Experience**

After many years in the retail food industry, James and Emma have become very sophisticated entrepreneurs who are knowledgeable of the food business, consumer tastes and consumer preferences. The past six years in the manufacturing of food for distribution has been a growth experience, partly due to their discovery of wider audiences interested in their product, but also because of managing their supply chain, both domestically and in the European Union. Their experience has allowed them locate new customers through a product diversification strategy that has increased their revenues year over year.

## **Export Challenge**

In the first three years, the founders operated very lean with James, Emma, their daughter and three food packers, all of whom work full time in the business. They hired a part-time bookkeeper that helped with the bookkeeping, once or twice a week and a part-time business/tax lawyer to address business filings. In the past three years, as revenues grew, they hired two sales personnel—one to manage domestic sales and another to manage international sales—and another four personnel to work as packers.

FGH has three challenges. One is the constant pace and feeling that they are woefully understaffed for the volume of the products manufactured, distributed and sold. The second is their lack of capital to innovate with new capital improvements and to hire new staff. The third is their own steep learning curve relating to the expansion into new international markets, such as BRICS (Brazil, Russia, India, China and South Africa). No employees have time to get away to get additional training or to travel to locations that might be sources of product expansion.

## **Financing The Growth**

FGH is seeking to raise \$700,000 to finance three aspects of their operations. First, FGH would like to hire managerial staffing skilled in international business consulting, market development and sales. Second, the company seeks to expand the manufacturing plant by adding some automation features and enhancing efficiencies to produce their product

distribution in new international markets. Third, the company wishes to hire additional operational staff and train current employees.

FGH founders are open to a variety of financing options, but they do want to understand the pros/cons and risks/rewards of each available financing option. At this stage of its life cycle in growth, FGH no longer relies on financing from family, friends, the owners' own credit cards or seed capital. These sources were tapped during the first two years of the startup and allowed the company to grow nicely. However, nearing its seventh year in business, it is now classified as an emerging-growth company. However, they remain a small private company unable to avail itself of venture capital financing, private placement and public-offering financing. Whether it is the amount of the money needed or the stage it is in the business, those options aren't considered at this time.

**FGH Company 4-Yr Pro Forma Income Statement (Table 3)<sup>75</sup>**

	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
<b>Revenue</b>	1,000,000	1,100,000	1,320,000	1,650,000
<b>Cost of Goods Sold</b>	354,000	360,000	375,000	400,000
<b>Gross Profit</b>	646,000	740,000	945,000	1,250,000
<b>Direct Expenses</b>				
Salaries and Wages	195,000	275,000	315,000	355,000
Rent/Mortgage	20,000	50,000	50,000	50,000
Communications/ Tech	5,000	7,000	8,000	10,000
Insurance	4,000	5,000	5,000	6,000
Travel & Living	3,000	4,500	7,000	14,000
Misc. Expenses	6,000	8,000	15,000	25,000
<b>Total Direct Expenses</b>	233,000	349,500	400,000	460,000
<b>Operating Margin</b>	413,000	390,500	545,000	790,000
<b>General and Administration Expenses</b>				
Legal & Accounting	45,000	55,000	65,000	75,000
Marketing & Advertising	35,000	50,000	65,000	80,000
Depreciation – Buildings	55,000	75,000	75,000	75,000
Depreciation – Equipment	38,000	51,680	51,680	51,680
<b>Total General &amp; Administration Expenses</b>	173,000	231,680	256,680	281,680
<b>Earnings before Interest &amp; Taxes</b>	240,000	158,820	288,320	508,320

**<sup>75</sup> Assumptions:**

1. Revenue Growth: 10% 2016 to 2017; 20% 2017 to 2018; 25% 2018-2019.
2. Salaries & Wages-2016: 2 owners@ 30K each, 3 factory workers @\$25k each, & 2 part-timers @ \$20K each, daughter @\$20K.
3. Salaries & Wages-2017: Add 2 factory workers @ \$25K each, 1 Sales consultant @ \$30K.
4. Salaries & Wages-2018: Add 2nd Sales Consultant @\$30K; \$10K for raises for employee.
5. Salaries & Wages-2019: Allocate \$40K for owner's raises and commissions for sales consultants.

**Timetable for Facility Upgrades, Hiring and International Product Rollout (Table 4)**

2015	2016	2017	2018	2019
(Yr1) Commence expansion of the manufacturing facility	(Yr2) Complete the expansion of the manufacturing facility	(Yr3) Hire second skilled sales consultant for international market development	(Yr4) Operations of sales force, packers and management	(Yr5) Operations of sales force, packers and management
Hire one skilled sales consultant to begin market development in BRICS locations. International training for existing employees	Hire two additional employees for plant operations to begin sales in two of the five BRICS locations	Hire two additional packers for the plant operation to grow sales in three of the BRICS locations	Exported Products rolled out in European Union and four of the five BRICS locations	Exported Products rolled out in European Union and in all five of the BRICS locations

### Projected Financing Budget (3 Years) (Table 5)<sup>76</sup>

At this time, FGH Manufacturing requires \$700,000. Below is a breakdown of how the funds sought would be used in the business for the next three years. See the Budget set forth below.

<b>Financing Budget (3 Years)</b>		
<b>Projected Revenues</b>		
Financing	<b>\$700,000</b>	
<b>Total Projected Revenues</b>	<b>\$700,000</b>	
<b>Projected Costs</b>		
Manufacturing Facility Expansion		\$220,000
Working Capital (Plant operations - Yr2 Hire Two added staff in the plant @ \$25,000 per employee and in Yr3 hire two additional staff @ \$25,000)		150,000
Skilled Sales Consultants (One for three years and one for one year @ \$40,000 per consultant)		160,000
Marketing Budget (\$20,000 per year for three years)		60,000
Miscellaneous and Unforeseen Costs		40,000
International Business Consulting Fees		20,000
Legal and Compliance Fees		50,000
<b>Total Projected Costs</b>		<b>\$700,000</b>

<sup>76</sup> **Assumptions:** FGH has an annual revenue growth of 25% percent per year, and they seek funding in the amount of \$700,000 to expand the business. They have strong trademarks, logos and intellectual property and have booked goodwill and increased market awareness.

## Lifecycle for Emerging Companies Seeking Capital

FGH has been growing for several years with a fairly predictable lifecycle. Typically for growing companies like FGH, the company “usually finance[s] its business through investments from friends and family, then perhaps from angel investors, and finally, if the company is successful, from venture capital firms.”<sup>77</sup> For businesses affiliated with wise legal counsel, the company could do small rounds of financing based upon available exemptions under the Securities Act. However, these securities would be classified as restricted securities subject to transfer restrictions.<sup>78</sup>

The next step in the growing company’s lifecycle would be to be considered for an Initial Public Offering, and if this was successful, consider becoming a public company under the securities laws. FGH is not at the point of being a public company and actually may have reservations about this next step. “Many companies have concluded that going public might not be the desirable liquidity event and remaining private longer or considering acquisition alternatives may be appealing.”<sup>79</sup>

Economic scholars have found that “firms most vulnerable to exit experience the largest survival effects from loan receipt.”<sup>80</sup> The vulnerable firms are those that are young and face dealing with the “valley of death.”<sup>81</sup>

**Question:** If you were advising the Smiths, which vehicle would you recommend that they use to finance their expansion and why?

**Second Question:** What would be the pros/cons and risks/rewards of raising \$700,000 through the new crowdfunding framework as an alternative to other sources of funding?

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77 Ze’ev D. Eiger, David M. Lynn & Anna T. Pinedo, MORRISON FOERSTER, *Jobs Act Quick Start: A brief overview of the JOBS Act 2016 Update*, at 5, available at <http://www.mofo.com/~media/Files/PDFs/jumpstart/140700JOBSAct.pdf>.

78 *Id.* at 57.

79 *Id.* at 6.

80 David Brown, John S. Earle & Yana Morgulis, *Job Creation, Small vs. Large vs. Young, and the SBA 16*, (US Census Bureau for Econ. Studies Paper No. CES-WP-15-24, 2015), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2661480](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2661480).

81 *Id.* at 6.



### III. ALTERNATIVES TO CROWDFUNDING FINANCING

#### *A. From Bank Loans to Angel Investments*

For growth businesses like FGH, theoretically, a variety of financing would be available for amounts under \$1,000,000.<sup>82</sup> The chart below illustrates the variety of types of financing for \$1 million and under. For purposes of this article, financing such as venture capital financing and Initial Public Offerings (IPO's) are not seriously considered because FGH's request is for under \$1,000,000. More commonly, VC and IPO would fund greater dollar amounts, generally in excess of \$1 million dollars and for later-stage companies.<sup>83</sup>

*Friends and Family Financing* – This is defined as funding from members of the business owners' family and friends who provide loans for debt or cash for equity in the company. Family and friends' contributions are in addition to cash and other contributions provided by the owners themselves (commonly called bootstrapping). This early-stage financing is not discussed in this article because it is typically provided in the early stages of the business and not in this growth cycle of the business. Furthermore, the likelihood of FGH obtaining \$700,000 from family and friends would put them in a special class by themselves, and possibly the subject of another article.

Thus, for purposes of this article there are several available financing options to be considered. The alternative financing available to entrepreneurs is described below as follows:

*Bank and Government Loans* – One traditional way for a business to get capital is to obtain a loan from its bank, community development organization, small business investment company or other lender.<sup>84</sup> The business can also seek a guarantee of their loan from the SBA.

*Factoring* is the outright purchase of a business' outstanding accounts receivable by a commercial finance company at a "factor" which

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82 Sources include INDIANA VENTURE CENTER, SUCCESSFUL ANGEL INVESTING (January 2015) and DONALD F. KURATKO, *Chapter 8: Sources of Capital for Entrepreneurial Ventures*, ENTREPRENEURSHIP THEORY, PROCESS, PRACTICE 232 (2009).

83 DONALD F. KURATKO, ENTREPRENEURSHIP: THEORY, PROCESS, PRACTICE 181 (Cengage Learning, 10th ed. 2016) (noting that venture capitalists normally invest in later-stage companies and not startups, with 4300 capital deals in excess of \$48 billion invested by 2015).

84 JEROME A. KATZ AND RICHARD P. GREEN II, ENTREPRENEURIAL SMALL BUSINESS 500–01 (3d ed. 2014).

is typically between 70 percent and 90 percent of the receivable at the time the company purchases it.<sup>85</sup>

*Peer to Peer Lending* – In peer-to-peer networks, “the borrower gets a cheaper loan than the banks and credit card companies offer. The lender gets more interest than offered in the bank or the bond market. The lenders...take the risk that they may never see their money again...websites such as Prosper and Lending Club...function like a bank loan officer, taking loan applications, checking credit scores, employment and debt levels. They say they reject 90 percent of applicants. Lending Club, for instance, requires a minimum FICO score of 660. The national average credit score is about 690.”<sup>86</sup>

*Private Placements* – A private placement is a method of raising capital under Regulation D of the Securities Act, through several rules that allow for exemption for amounts up to \$1,000,000 in any 12-month period. Rule 504 allows for private placements up to \$1 million dollars; Rule 505 allows for placements up to \$5 million dollars with no more than 35 non-accredited investors and unlimited number of accredited investors; and Rule 506 allows for placements in excess of \$5 million with no more than 35 non-accredited purchasers and an unlimited number of accredited purchasers.<sup>87</sup>

#### B. *Seven Factors to Decide How to Finance the Business*

For purposes of this analysis, we have focused on seven determinants that we contend would likely be a part of the entrepreneur’s financial decision making. These determinants would include financing costs, public disclosures raising privacy concerns, the financing feasibility, ease of access, shareholder governance, and owner’s equity dilution. These considerations are quite different than what a likely investor would have in making a decision to invest. Their decision-making tree would consider

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85 Tom Klausen, *The Difference Between Factoring and Accounts Receivable Financing*, ALL BUSINESS, <http://www.allbusiness.com/the-difference-between-factoring-and-accounts-receivable-financing-14847411-1.html>. (last visited Mar. 9, 2016).

86 Jim Gallagher, *Is Lending to Strangers Smart Investing*, ST. LOUIS POST-DISPATCH (Jan. 27, 2013), [http://www.stltoday.com/business/columns/jim-gallagher/is-lending-to-strangers-smart-investing/article\\_7f79bb0b-5c6a-5399-a4b3-f352ba8fc877.html](http://www.stltoday.com/business/columns/jim-gallagher/is-lending-to-strangers-smart-investing/article_7f79bb0b-5c6a-5399-a4b3-f352ba8fc877.html).

87 DONALD F. KURATKO, *supra* note 86, at 179.

a host of economic, personal, and other soft factors before making a decision to invest. Likely considerations would include the investor's return on investment, their risk tolerance toward investment loss, interest in the entrepreneurial business, the strength of the business financials and possibly geographic considerations of their close proximity to the entrepreneur. On the other hand, lenders—such as in Peer to Peer networks, banks and government lenders—would consider other factors such as credit worthiness of the business, guarantees of the business owners, strength of the financials, length of time in business and the experience of the company management.

### **Investment Crowdfunding vs. Alternative Financing Alternatives (Determinants) (Table 6)**

- Entrepreneur Financing Costs
- Public Disclosures and Privacy Concerns
- Ease of Access
- Anti-fraud Concerns
- Failure Rate of Funding
- Shareholder Governance
- Owner Dilution and Reduction in Control

These determinants are considerations that an Issuer would undertake:

- Entrepreneur Financing Costs – actual expected total costs of the financing (See Exhibit 3 discussing estimates and type of costs to obtain financing from crowdfunding);
- Public Disclosures and Privacy Concerns – actual public disclosures required by the funder or regulatory scheme (See Exhibit 1 discussing the actual public disclosures required for crowdfunding);
- Ease of Access – ability of the entrepreneur to gain access to the funder or funding portal;
- Anti-fraud Concerns – the real or perceived concerns (and quantification of costs that ensue) from misrepresentations, omissions of fact, erroneous financials and the liability to

investors from those misstatements or omissions;

- Failure Rate of Funding – the real or perceived reality of actually obtaining the entrepreneur’s goal of financing at the amount requested;
- Shareholder Governance – the real or perceived concern about managing a large number of investors. “The rule of thumb when raising funds, is the fewer the investors, the better.”<sup>88</sup>
- Owner Dilution and Reduction in Control – the Owners real or perceived concerns about giving up control of their company and diluting the owners’ share ownership.

A high favorability would give the greatest point score and be the best and preferred course of action. A neutral marker would be second best, and a low favorability ranking would not be a preferred course of action, unless there are no other alternatives. When we look at the aggregate, the scores from favorable to unfavorable, we would get a glimpse at the course of action an entrepreneur might choose to proceed for the financing decision. The basic assumption is whether those alternatives are available to the Issuer.

### C. *Issuer Goals (Access to Capital, Job Creation, and Innovation)*

In the course of establishing a business, an Issuer typically incorporates or organizes with a mission in its organizational documents. The process of incorporation has become simpler, with approximately 64 percent of Fortune 500 companies incorporating or re-incorporating in Delaware.<sup>89</sup> Ideally, an Issuer has a sound business concept, which provides it a competitive advantage over the sale of its products, services and innovations. Better yet, the Issuer has a business plan, which includes details for a period on the manner in which the business will operate and be profitable. Last, an established and profitable business with a mission

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88 See Usha Rodriguez, *Securities Law’s Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3432 (2013).

89 DOUGLAS M. BRANSON ET AL., *supra* note 39 at 176, 185.

and sound business concept and plan must also develop ways to be sustainable in the market in which it competes. Sustainability means access to capital, job creation and automation and it has been found that without needed funds, an Issuer would face the “valley of death.”<sup>90</sup>

FGH’s company goal is to grow its business, both domestically and internationally. FGH seeks to raise \$700,000 to finance three aspects of their operations. First, FGH seeks to hire managerial staffing skilled in international business consulting, market development and sales. Second, FGH seeks to expand its manufacturing plant through automation features and efficiencies to produce their product distribution in new international markets. Finally, FGH, seek to hire additional operational staff and train current employees. These goals are in line with the goals advanced by the JOBS Act.

There is nothing in the FGH fact pattern that suggests a risk of business failure, bankruptcy or lack of credit worthiness. Also, nothing suggests naivety or the remote possibility that FGH’s growth goals can’t be exceeded, except that its goals won’t happen without access to capital. What we don’t know is FGH’s ability to capture the capital it needs through investment crowdfunding or whether it must avail itself of another option. In other words, does FGH have the expertise of internal and external professionals to manage the compliance costs and requirements of a crowdfunding campaign and does it have the vision to manage foreseeable risks? The next section, we discuss in further detail these Issuer realities in choosing to take on an investment crowdfunding campaign.

*D. Issuer Reality (Disclosure, Filing and Termination Requirements, Costs, and Liability)*

The folly in a federal law’s ability to stimulate enterprise growth is the balance between political rhetoric on the one hand and actually creating a realistic road to job creation and access to capital on the other. The theoretical idea that this framework will promote progress for growth enterprises who seek to issue stock is a work in progress. Assessing the outcomes of who actually gains access to the marketplace, and who doesn’t, as well as the unintended consequences of the regulations, will

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<sup>90</sup> Brown, *supra* note 83, at 6.

give us more data to determine if Regulation CF is positive for enterprises seeking access to capital, profitability and job creation.

Three reservations that high-growth enterprises would have before utilizing this investment based crowdfunding platform would be: 1) Their ability to comply with these complex federal regulations; 2) That the costs are competitive and preferably cheaper than other available options; and 3) That the Issuer is able to minimize liability when things go wrong. Below, we will address Issuer requirements, expected costs and then review proactive measures that an Issuer should take to minimize risk and avoid liability.

### 1. Compliance Requirements and Costs

The SEC recognized that there will be costs for Issuers to raise funds through crowdfunding. Commentators on the proposed rules identified the main costs for issuers in securities-based crowdfunding offerings as: intermediary fees; the costs of preparing, ensuring compliance with, and filing of Form C and Form C-AR; and the cost of accounting review or audit of financial statements.<sup>91</sup> Each of these cost categories requires some discussion to better understand why investment crowdfunding will be one of the most expensive ways to raise capital.

First, complying with the SEC requirements will be one of the Issuer's greatest expenses and will undoubtedly create significant costs for Issuers like FGH who seek to raise capital. There are at least three underlying reasons for the significant costs due to compliance. Two reasons are the breadth and the depth of the disclosures, and the third reason relates to the paramount need for the disclosures to be accurate and complete before soliciting potential investors. The SEC's *basketful* of disclosure requirements are set forth in Exhibit 1 and show twenty (20) different data points that will need to be disclosed, in addition to annual reporting. Each data point will require time to develop the details and precision to check the information for accuracy.

To better understand how these disclosures present a more

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91 SEC, CROWDFUNDING 402 (2015), <https://www.sec.gov/rules/final/2015/33-9974.pdf>.

expensive regulatory regime from a more simplistic and cheaper online approach (not currently selected by the SEC), one can easily turn to online transactions that occur daily, such as a book sale over the internet or even imagine a fictional, but simplistic, stock sale. It is not difficult to envision a simplistic online stock purchase and sale transaction that is similar to an online book purchase and sale transaction. Setting aside the SEC's concerns about investor protection, such a transaction is conceivable, and could well be a foreseeable transaction in an idealistic future.

For FGH, imagine this Issuer providing an offering for the sale of \$700,000 worth of stock to raise capital for the company online, (maybe through its own website or through some other internet portal). Websites are easily created, and technology for financial transactions is also easily includable on the web or via application. Similarly, consider a hypothetical smaller enterprise, Suzie's Herbal Marketplace, LLC (Suzie's), that seeks to raise a smaller dollar amount, i.e. \$100,000, in a short period of time. Suzie's or FGH could design a creative stock certificate, take a .jpeg photo of the certificate and upload it onto the company website and begin to solicit investors to buy blocks of \$1,000 shares of stock in the business. In Suzie's case, the company would only need to sell 100 stock certificates at \$1000 in order to be able to raise \$100,000. In this simple, idealistic, online marketplace, FGH could do the same type of online transaction and sell 700 stock certificates for \$1,000 each to interested investors. FGH could potentially raise \$700,000 very easily. Of course, there would be some minimal amount of information necessary for the stock purchase transaction to be completed. For the buyer to be interested, the Issuer would provide its Company name and description, amount of the stock, date of valuation, location of the business and stock shipping information. The Company also would need information about the investor, including investor identification information for the stock registry (name, address, etc.), credit or debit card information and shipping instructions.

Every day, in our global, online marketplace, there are simple transactions that are efficiently completed with little fanfare. As an example, daily, an author can offer the sale of his or her books to interested book readers. The author can sell the book online through many vendors, like Amazon.com, to ready and willing book buyers. The minimal and simple information that an author would need to include on the website would be the book title, the author and publisher's name, the

price of the book, number of pages, a short summary to generate interest with a cover picture and some shipping information. If this description interests the buyer, the buyer then could buy the book by using his or her credit or debit card and settle the transaction. Within a short time, the book arrives in the mail or maybe in downloadable fashion on a kindle or other book reader. In the best case, the author of the book is satisfied that the book has been sold at a fair price and the book buyer is satisfied with his or her book purchase.

Unfortunately, in the scenario of investment crowdfunding, the great concern for investor protection outweighs simplicity, efficiency and ease of access to capital for Issuers. In Regulation CF, the SEC requires the twenty (20) different data points of information before that Issuer can effectively sell its stock to a willing buyer (as set forth in Exhibit 1). Ensuring disclosure compliance would be tantamount to performing a full dress rehearsal before a sale of stock ever takes place. A wise Issuer would need to check off whether the basketful of disclosures are complete, accurate and ready to be disseminated to the investor community.

However, that type of dress rehearsal has significant costs involved. The costs for each one of these items will add up, and generally speaking, you get what you pay for and sometimes, you get less – such as in the case where a company disseminates its \$49 business plan where they fill in the blanks in order to be able to disclose this quickly prepared business plan. Query, whether this business plan reflects the Issuer's operations, financials, and marketing plan or is it a template of a generic company? Is the company's business plan outdated and in need of updating? An outdated business plan, one that might include the names and information of former employees, information about abandoned programs, products and services would be at best useless and at worst, a potential liability. Thus, Issuers will need to pay the costs for a current or updated business plan that reflects the Issuer's operations, financials, and marketing plans. Ideally, these business plans are developed by trained business or legal professionals who can write up what is actually occurring at the Issuer's place of business.

Each of the SEC compliance requirements has embedded within them staffing requirements that raise the cost. As another example, the



SEC requires the Issuer disclose on their website where their annual report and updates will be posted. This requirement presumes that the Issuer has staffing to develop, operate and maintain updates on its website. This technical and administrative support function adds a layer of administrative costs to the Issuer's costs, whether that is through internal staff, independent contractors or contracts with the Intermediaries (broker dealers and funding portals).

In Exhibit 2, we set forth the SEC requirements regarding Issuer progress filings and termination obligations. An Issuer is required to provide progress reports, either updated by the Issuers or updated by their Intermediary. It would be expected that a highly sophisticated Issuer would look within its own staffing to determine if they have the capacity to complete these progress reports and filings. If the staffing, expertise or capacity is not readily available, internally, the Issuer would need to get these services completed by the Intermediary involved in the crowdfunding campaign. The reports include progress updates on Form C-U, amendments on Form C-A, and Form C – cover form and annual reports. This also presupposes that a staff person or other party is assessing the necessity of the filing of these forms and then actually completing them. Failure to complete these forms risks Issuer liability and noncompliance under the rules.

To scale the level of costs of compliance under Section 4(a)(6) of the Act, the SEC provides Issuer Estimated Costs set forth in Exhibit 3. Each of these requirements will bear a hefty cost on an Issuer such as FGH. FGH would likely incur Issuer compliance costs ranging from a low of 5% to a high of 7.5% of the amount of capital to be raised. That translates to costs on the low end of \$35,000 (thirty-five thousand dollars) to costs on the high end of \$52,000 (fifty-two thousand dollars). Thus, for a \$700,000 stock transaction, the percentages are as high as 7.5% of the transaction, and that does not count the costs that may be passed on to the Issuers by their respective Intermediaries (Broker-Dealer or Funding Portals).

The actual amounts of the pass-through costs that will flow from Intermediaries or Funding Portals to Issuers, such as FGH, are uncertain. It can be expected that the Intermediary, new Broker Dealer and existing Brokers have estimated costs that will depend on their own circumstances

and phase of startup that they are in. In attachment Exhibit 4(a), an estimated cost for a Broker Dealer to comply with requirements under the Act and file the proper forms is over \$315,000. It would be expected that their costs would be spread amongst their clients, Issuers, but the actual amount of that allocation is unknown. As these types of transactions begin, a future research project would be to track the allocations per Issuer to determine the actual costs and whether there may be variations by geography, size of deal or competitive advantage of the broker dealer.

Exhibit 4(b) sets forth estimated costs for Funding Portals, which has as its startup costs, \$135,000 and Exhibit 4(c) provides the estimated cost of \$115,000 for startups that are Intermediaries already registered as broker dealers. Depending on FGH's choice of Intermediary and the level of services required, the actual costs may vary.

To comply with Regulation CF, Intermediaries (Broker-Dealers and Funding Portals) will play a very important and fundamental role. Their role is one that neither a federal government agency like the SEC nor a state governmental department can play. It may have been a role that a savvy Issuer with a high tech staff and a broker could have done, however, the SEC foreclosed that option.<sup>92</sup> Not only will Intermediaries and funding portals create the venue for the offering, but also they will select and evaluate the Issuers to allow on their funding portals. It is the Intermediaries that will monitor the process from beginning to end. Undoubtedly, their role will be compensated and will not be based on the success or the failure of the Issuer. Estimates of the costs for Intermediaries range from the lowest cost for those who are brokers already, to the midlevel of those who will serve as only funding portals without the broker licensing, to those that will be a new broker setting up an infrastructure to do crowdfunding.

Estimates of the costs for Intermediaries range from the lowest cost for those who are brokers already, to the midlevel of those who will serve as only funding portals without the broker licensing, to the highest level for new brokers setting up a new infrastructure for crowdfunding.

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<sup>92</sup> The SEC received letters questioning the need for Intermediaries in light of the fact that the internet is so broadly and publicly available.

The level of uncertainty around costs to the Issuer remains in light of the novelty of these new platforms and the Intermediaries expectations around returns on investments. Does the Intermediary view this startup as research and development and not pass along the costs to Issuers or do they view it as cost allocation to be shared by the new users? Time will tell.

The SEC projected that 50 Intermediaries may come from brokers already registered with the Commission and 50 Intermediaries may register as Funding Portals.<sup>93</sup> As a result of these added and incremental costs, the SEC estimates that compliance could result in transaction costs for issuers of 5% to 15% of the offering made in reliance on Section 4(a)(6).<sup>94</sup>

There is a relationship between costs, risk reduction and liability. At the same time, there are those lucky sellers that put very little upfront costs into their transactions, suffer few damages, and still get a significant return on their investment. But what is more realistic is that proactive Issuers that plan, garner their time, resources and output of expenditures, are more likely to reduce their risks of inaccurate disclosures, material omissions, outdated data and miscalculations, and are able to alleviate the potential for liability and damages.

## 2. Minimizing Potential Liability and Risk

Issuers will need to address what proactive measures they should take in order to reduce risks related to issuing stock. Within Section 4A(c) of the JOBS Act, Issuers, through their officers and directors, can incur liability if the Issuer makes an “untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.”<sup>95</sup> As discussed earlier, an Issuer would need to assess whether they have the internal staffing to check and double-check the required disclosure information. How does one detect if there is an omission, without an audit or other innovative solution? In order to reduce the risk of potential liability from these offerings, it is possible that

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93 *Id.* at 429.

94 *Id.* at 338.

95 ABA Business Law Section, *supra* note 11, at 982.

sophisticated Issuers will need to engage added staffing, purchase insurance, and hire needed resources. It is expected that these measures will increase transaction costs. To the extent that an Issuer fails to collect the proper data and verify the data's accuracy, that will increase the risk of liability under the Act.

Not surprisingly, the SEC did not foreclose a 10b-5 action in cases of manipulation and deceptive practices.<sup>96</sup> Among the litigation risks an Issuer may confront, the risk of a securities class action lawsuit may be among one the most serious.<sup>97</sup> The problem is that this type of litigation is not only complex and time-consuming, but is also very expensive to defend.<sup>98</sup> As if these liability risks were not enough, the applicable law is constantly evolving.

Although this article focuses on whether investment-based crowdfunding is a good idea for an Issuer, it should be noted that there is a symphony of dissatisfied. For an Investor, the greatest cost is the cost of losing his or her capital pledged. In those cases, where States are privy to capital failures or investors file complaints, states are not restricted from taking enforcement actions against Issuers for fraud or deceit.<sup>99</sup> Furthermore, Issuers can be liable under the Securities Exchange Act, Section 9(a)(4), which prohibits "false or misleading statements made to induce a securities transaction."<sup>100</sup> Not only will Issuers need to have a level of confidence that statements made going forward are neither false nor misleading and Intermediaries, will also need to have that confidence too, because they also can share in this potential liability.

For FGH, there is some good news regarding protection from potential liability. Under Rule 502 of Regulation CF, the SEC adopted a

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96 ABA Business Law Section, *supra* note 11, at 982. *See also* 17 C.F.R. § 240.10b-5 (2015).

97 Robert F. Carangelo et al., *The 10b-5 Guide: A Survey of 2010-2011 Securities Fraud Litigation*, WEIL, GOTSHAL & MANGES LLP (September 2012), at iii, [http://www.weil.com/~media/files/pdfs/10b\\_5\\_Guide.pdf](http://www.weil.com/~media/files/pdfs/10b_5_Guide.pdf).

98 *Id.*

99 ABA Business Law Section, *supra* note 11, at 983. Refer also to footnote 417 on that page.

100 *Id.*

three-prong test to provide Issuers “a safe harbor for insignificant deviations from a term, condition, or requirement of Regulation CF.”<sup>101</sup> The three-prong test requires an Issuer to prove that the: i) failure to comply was insignificant with respect to the offering as a whole; ii) Issuer made a reasonable and good-faith effort to comply with Regulation CF; iii) Issuer was unaware of the failure to comply....as a result of a failure of an intermediary to comply....” Proactively determining what terms, conditions, or requirement may or may not be significant or insignificant will require forethought and maybe, a crystal ball.

The SEC and parties opposing the Crowdfund Act raised additional concerns about Investor’s loss of capital due to abuse and fraud. However, there is another cost to consider here. An Investor may lose his or her investment, in whole or in part, for reasons unrelated to fraud or abuse. The loss of capital may be due to creative destruction by another industry or rise of a competing product, bearing no fault on the part of the Issuer or Intermediary. FGH hopes to export their brand-label sauces, seasonings and condiments to foreign countries, mainly located in the European Union. Yet, it is unknown whether there will be trade restrictions on their goods and services or whether a potential competitor is rising in those foreign countries. Some aspects of the future valuation of a stock are unknowable. Thus, it is impractical to expect an Issuer to have such clarity in vision that would alleviate the risk of creative destruction or trade restrictions. Yet, the Issuer must protect the company against losses that an investor may incur due to unforeseen circumstances. It is unlikely that investors will be sympathetic when and if they lose their capital.

The decision to invest capital in a deal, as Timmons and Spinelli contend, is “based on cash, risk, and time...and is subject to interpretation. The players’ perceptions of each of these factors contribute to the overall valuation of the venture and the subsequent proposed deal.”<sup>102</sup> What Investor would not want success?<sup>103</sup> The alternative to success, places

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101 ABA Business Law Section, *supra* note 11, at 981. *See also* 17 C.F.R. § 227.502.

102 JEFFREY A. TIMMONS & STEPHEN SPINELLI, JR., *NEW VENTURE CREATION FOR THE 21ST CENTURY* 457 (McGraw Hill, 7th ed. 2007).

103 *Id.* at 456. Timmons and Spinelli suggest fourteen characteristics of successful deals, which in this context is the purchase of stock exempted from the Securities Act. The

Issuers in jeopardy of lowered business valuations, loss of reputation and failure to attain their corporate goals.

**IV. EVALUATING THE RISKS AND REWARDS AND PROS AND CONS OF EACH ALTERNATIVE**

When we begin to analyze an Issuer’s financing options from favorable to unfavorable options, the point scores reveal a not-so-surprising pattern. If all things are equal, an Issuer would value keeping the costs of its capital low; control of the company rather than giving away shares; keep financial data and other trade secrets private; opt for minimal governance vs. greater governance by more shareholders, minimize risk and liability for errors, omissions or misrepresentations of facts, and actually getting the funding.

Table 8 below evaluates seven variants (Issuer Financing Costs, Public Disclosures/Privacy Concerns, Ease of Access, Anti-fraud concerns; Shareholder Governance requirements; failure rate of getting the funding and shareholder dilution) for each of the funding options. The seven determinants are listed across the top of the chart. The funding options are listed vertically on the left side of the chart.

With these two axis, we can begin to evaluate what an Issuer’s decision-making process might be in choices to be made amongst various funding options. Available funding choices may be: obtaining funding from family and friends (not useful for FGH since the facts suggest that they have availed themselves of this type of funding during the early stage of the business). Furthermore, friends and family financing is unlikely for an Issuer seeking the level of financing that FGH is seeking (amount of \$700,000 in later stage financing)); banks and government lending; factoring and accounts receivable; peer-2-peer lending; angel investing; private placement; crowdfunding (debt); and investment-based crowdfunding.

We evaluate each of the determinants as a unit, with three rankings for each funding option: Favorable, Unfavorable and Neutral. Each unit provides an evaluation that is added together for a total favorability

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purchaser takes on risk, but the liability may ultimately rest with the Issuer. *Id.*

ranking. A favorable ranking would create the greatest point score and is thus the best and a preferred course of action. A neutral ranking is second best and an unfavorable marker would result in the lowest point scores and not a preferred course of action, unless there are no other alternatives. When we look at markers and aggregate the scores from low to high, this exercise provides a glimpse at an Issuer's possible course of action. Will the company choose to proceed with investment crowdfunding or use another alternative?

### **Crowdfunding vs. Alternative Financing Alternatives (Pros and Cons) (Table 7)**

#### **Seven Determinants**

	<b>Issuer Financing Costs</b>	<b>Public Disclosures Privacy Concerns</b>	<b>Ease of Access</b>
Friends and Family Loans	Favorable (2)	Favorable (2)	Favorable (2)
Bank & Government Loans	Favorable (2)	Favorable (2)	Medium (1)
Factoring & Accounts Receivable	Unfavorable (0)	Favorable (2)	Favorable (2)
Peer to Peer Lending	Favorable (2)	Favorable (2)	Favorable (2)
Angel Investment	Neutral (1)	Favorable (2)	Unfavorable (0)
Crowdfunding (Debt)	Unfavorable (0)	Unfavorable (0)	Favorable (2)
Crowdfunding (Investment -Equity)	Unfavorable (0)	Unfavorable (0)	Favorable (2)
Private Placement (Equity)	Unfavorable (0)	Favorable (2)	Favorable (2)

**(Table 7 Continued)**

	<b>Anti-Fraud Concern</b>	<b>Shareholder Governance Requirements</b>	<b>Failure Rate of Getting the Funding Needed</b>	<b>Shareholder Dilution</b>
Friends and Family Loans	Favorable(2)	Favorable (2)	Unfavorable (0)	Favorable (2)
Bank and Government Loans	Favorable (2)	Favorable (2)	Neutral (1) (Depends on Credit Score)	Favorable (2)
Factoring & Accounts Receivable	Favorable (2)	Favorable (2)	Neutral (1) (Depends on Credit Score)	Favorable (2)
Peer to Peer Lending	Favorable (2)	Favorable (2)	Neutral (1) (Depends on Credit Score)	Favorable (2)
Angel Investment	Neutral (1)	Neutral (1)	Unfavorable (0)  (Depends on Access to Angel Networks and Angel Interest)	Neutral (1)
Crowdfunding (Debt)	Unfavorable (0)	Favorable (2)	Neutral (1) (Depends on Access to Intermediary Investor Risk Tolerance)	Favorable (2)
Crowdfunding (Equity)	Unfavorable (0)	Unfavorable (0)	Neutral (1) (Depends on Access to Intermediaries and Investor Risk Tolerance)	Unfavorable (0)
Private Placement (Equity)	Favorable (2)	Unfavorable (0)	Neutral (1)  Depends on Access to Investors	Unfavorable (0)



When we rank each determinant by the total point scores, not so surprisingly, it illustrates that investment crowdfunding would likely be the least-favored alternative. The way we arrive at the numbers is set forth in Table 9 below. The categories are added together for a total favorability ranking. These rankings are viewed best from the perspective of a reasonable manager who is evaluating the variables from an objective point of view. It is conceivable that an Issuer could be an outlier and think (or feel) completely different from his or her peers. An example would be an Issuer that enjoys complete transparency for the business and hence, the idea of providing public disclosures would be considered a good thing and ranked favorably. Another oddity or unusual way of looking at the determinants is that an Issuer might tout a preference to spend more money on financing that could be obtained more cheaply, maybe for bragging rights. Consider the Issuer who wants to be the first to do an investment crowdfund in their industry. A more objective Issuer would weigh the differential costs of a bank loan or private placement over the cost of raising the capital through crowdfunding.

#### Ranking with Inputs (Table 8)

From Most To Least Preferred Choice	Type of Financing	Point Score
1	Peer to Peer Lending	13
2	Bank and Government Loans	13
3	Factoring and Accounts Receivable	12
4	Family and Friends	12
5	Private Placement	7
6	Crowdfunding (Debt)	7
7	Angel Investing	6
8	Crowdfunding (Equity)	4

Peer to peer networks rank as one of the most favorable financing options for FGH to consider, principally because there appears to be little downside in the determinants. This option is tied with bank and

government loans, especially in the event that FGH's credit rating is good. The best part for an Issuer like FGH is that the company can maintain control of their family-oriented emerging business. Neither of these options causes any shareholder dilution because no stock is offered. Additionally, these options don't have significant compliance costs or pass through Intermediary costs. Factoring and accounts receivables do have high financing costs, which is one of the reasons it does not score favorably. However, it too does not cause shareholder dilution and FGH can maintain its private information. For Angel investors and family and friends, they are not necessarily accessible to most Issuers. Without more research on the availability and interest by Angel investors in FGH, this option would also likely be off the table. For FGH, we know that family and friends weren't an available option, although for early stage investment that alternative is a lifesaver. With respect to the private placement offerings, there would be shareholder dilution concerns, similar to investment crowdfunding, but without all the extra Intermediary pass-through costs. Crowdfunding through debt instruments would have compliance requirements and public disclosures that may not be favorable to the reasonable Issuer, which detracted from its favorability ranking.

Last, but not least, investment crowdfunding ended up as the worst alternative for FGH. The only favorable ranking raising capital in this manner was the ease of access to potential investors. How much better can it be than having widespread access to a crowd of investors via the internet, Facebook, Linked-In or Twitter? The only problem is that every other determinant does not rank favorably. No privacy, too costly, subject to liability and shareholder governance issues. Also, there is no guarantee that the Issuer will actually be able to raise the funding needed.

A future research project could be to test these determinants with surveys to a variety of Issuers in different parts of the country. It would be interesting to find out whether Issuers in certain geographic areas have different available options and hence, affect their preferences and choice. For example, in the event that private placements are quite common in California to raise capital up to \$1,000,000, there may be more providers, experts, lawyers, and accountants who can provide access to capital through those measures. Alternatively, with a vibrant banking and commercial sector in Missouri, FGH may find it more feasible to utilize

this measure because it is familiar and cost effective.

Just as accountants and some lawyers avoided limited liability companies when LLC's were first conceived in the early 1990's, investment crowdfunding will likely be avoided due to concerns about potential liability and lack of precedent in case law. However, as time has shown, LLC's have become accepted and are commonly the number one choice for an entity. As costs come down and liabilities become better understood, the preference for investment crowdfunding may change for the better.

## V. CONCLUSION

The impact of the Crowdfund Act and the subsequent Regulation CF in its best scenario may be a positive *game enhancer* for Issuers who seek investment capital to address important business goals. Investment-based crowdfunding is a variation from previous crowdfunding concepts, like Indiegogo and Kickstarter. It is also different from raising capital through private placements to limited numbers of accredited and non-accredited investors. This new framework allows Issuers to legally raise sums of money from a crowd of individuals over the internet without registering their securities.

The question of this article was to answer whether investment crowdfunding truly will be a game changer for Issuers seeking to raise capital for their businesses. From the hype, and at first blush, it seemed that Issuers would flock to investment-based crowdfunding via the internet, to the detriment of naïve investors. However, considering the breadth and depth of the SEC regulatory requirements, public disclosures and a variety of other factors, crowdfunding will most likely be a last resort for Issuers that cannot avail themselves of other alternatives discussed in this article (e.g., Commercial bank financing, Private Placement, Peer-to-Peer and other Angel networks or even debt Crowdfunding).

Breadth and depth of the compliance and filing requirements are concerns for an Issuer because there will be costs related to internal and external staffing needs to address the compliance, the need to take extra precautions to minimize risk and liability, as well as the likelihood of shareowner litigation and dilution. A closer eye on the costs leads us to the conclusion that an investment crowdfunding capital campaign won't

be as favorable to Issuers as other alternative financing options. For those Issuers that do seek investment-based crowdfunding, the Issuers will need sound accounting, business management and legal representation in light of the complexity of the regulations. Additionally, Issuers such as FGH would need to avail itself of an Intermediary, whether it is a Broker Dealer or a Funding Portal who is chosen to handle the stock offering. Query, whether there are available Intermediaries ready, willing and able to provide the level of funding that FGH needs to expand their Missouri company. However, as time goes on, Intermediaries will develop an expertise nationally and be in a better position to provide services to Issuers, ideally passing along the lowered allocated costs of a well-seasoned startup.

There remain serious questions about the risks of liability and what are the best ways to minimize liability, maximize profitability and stay sustainable. However, with any new concept, time will settle the marketplace. Similar to the adoption of limited liability companies in the early 1990's, the adoption of this new framework for investment crowdfunding will likely evolve in a few years. In the next few years, there will be a better understanding of how Issuers can successfully utilize this framework and avoid liability. The development of precedent in case law and the continuing review by commentators as well as the SEC, will provide feedback about this alternative financing.

Although the JOBS Act and Regulation CF call for simplification and an efficient system, the worst consequence is that there is nothing simple or efficient about the SEC's compliance requirements for emerging-growth businesses. The risks to avoid fraud or even the appearance of fraud are great for Issuers like FGH and there are costs that must be managed proactively in order to prevent mistakes, omissions, fraud and abuse. Unfortunately, not only will the early concerns of adverse impacts to Investors raise the possibility that Regulation CF will frighten some Investors away from participating, but also the unfavorable rankings of the seven factors discussed in this article will likely keep Issuers away too.

Avoidance may deflate the marketplace for investment crowdfunding in the early stages. With these concerns, it seems unlikely

that investment-based crowdfunding will overtake traditional crowdfunding any time soon, which is unfortunate for Issuers and for our economy. The impetus for this legislation was to help Issuers with the very goals Congress and the Executive Branch sought to advance: job creation, capitalization, maximizing profitability and sustainability. This means that these goals won't be attained while the current regulatory framework is in place.

With the SEC's Regulation CF continuing focus on overcoming the Investor risk (fraud and abuse), it ultimately creates high business costs that will affect an Issuer, or in this case, FGH's bottom line. Costs affect returns on investment and may result in two types of Issuers taking advantage of investment-based crowdfunding. One type would be sophisticated companies (on the one hand) who have an efficient machine in place - a machine that includes all of the necessary resources and wherewithal to undertake the necessary compliance, filings, fees and prevention. The other type would be companies lacking alternative financings (on the other). These companies may have low credit ratings, without access to other means of capital and turn to investment crowdfunding as the only option available.

With these complex constraints placed on Issuers, one result is that fewer jobs will be created on Main Street, a few more will be created on Wall Street and Issuers will continue to evaluate their options on the best way to raise capital (as always). When one takes off their rose-colored glasses, investment-based crowdfunding does not appear to be the easy, simple solution advocates of emerging growth entrepreneurs had hoped it would be. However, on a brighter note, there is still time to evaluate what is occurring in our new era of investment crowdfunding and for sure, some undercapitalized Issuers will get funding that they couldn't have gotten before, even if it is at a high cost.

## EXHIBITS

### EXHIBIT 1

#### Issuer Disclosures

- Information about its president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer and any person routinely performing similar functions;<sup>104</sup>
- Description of the business and business plan (a non-exclusive list of the types of information to be disclosed);<sup>105</sup>
- 20 Percent Beneficial Owner as of the most recent practicable date, but no earlier than 120 days prior to the date the offering statement report is filed;
- The use of proceeds (Reasonably-detailed description of the purpose of the offering, such that investors are provided with enough information to understand how the offering proceeds will be used);<sup>106</sup>
- Target offering amount and the deadline to reach the target offering amount;<sup>107</sup>
- Whether the Issuer would accept investments in excess of target offering amounts, and, at the commencement of the offering, the maximum amount the Issuer would accept;<sup>108</sup>
- The process to cancel an investment commitment or to complete the transaction once the target amount is met, including statements of timing;<sup>109</sup>
- The Offering price of the securities or, in the alternative, the method for determining the price, so long as before the sale each investor is provided in writing the final price and all required

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104 See 17 C.F.R. § 227.201(a)-(c) (2016).

105 See 17 C.F.R. § 227.201(d).

106 See 17 C.F.R. § 227.201(i).

107 See 17 C.F.R. § 227.201(g).

108 See 17 C.F.R. § 227.201(h) .

109 See 17 C.F.R. § 227.201(i) and instruction to paragraph (i).

disclosures;<sup>110</sup>

- A description of the Issuer's ownership and capital structure, including language specifying the beneficial ownership calculated no earlier than 120 days prior to the date of the filing of the offering statement or report;<sup>111</sup>
- Additional disclosures (name, SEC File number and Central Registration Depository number, as applicable of the intermediary conducting the sale; amount of compensation paid to intermediary; legends in the offering statement; current number of employers of the Issuer; Material factors that may make an investment with the Issuer speculative or risky, material terms; exempt offerings offered within the past three years; and related party transactions);<sup>112</sup>
- The location on the issuer's website where investors will be able to find the Issuer's annual report and the date by which such report will be available on the Issuer's website;<sup>113</sup>
- Whether the Issuer or any of its predecessors previously has failed to comply with the ongoing reporting requirements of Regulation Crowdfunding;<sup>114</sup>
- Any other direct or indirect interest in the Issuer held by the intermediary, or any arrangement for the intermediary to acquire such an interest;<sup>115</sup>
- Provide a description of the material terms of any indebtedness of the Issuer;<sup>116</sup>
- Provide disclosure about the exempt offerings that Issuer conducted within the past three years;<sup>117</sup>

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110 See 17 C.F.R. § 227.201(l).

111 See 17 C.F.R. § 227.201(m).

112 See 17 C.F.R. § 227.201(o) – 201(y). Final rules allow for intermediary compensation to be disclosed either as a dollar amount or percentage of the offering amount or as a good faith estimate if the exact amount is not available.

113 See 17 C.F.R. § 227.201(w).

114 See 17 C.F.R. § 227.201(x). (Allowance is made for cross-referencing.)

115 See 17 C.F.R. § 227.201(o)(2).

116 See 17 C.F.R. § 227.201(p). (Rule does not require the identities of the creditors.)

117 See 17 C.F.R. § 227.201(q).

- Transactions with any related party transactions, including any person who is, the beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities;<sup>118</sup>
- Disclose any material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading;<sup>119</sup>
- Describe the financial condition of the Issuer (liquidity, capital resources and historical results of operations, to the extent material);<sup>120</sup>
- Financial disclosure requirements based on the amount offered and sold in reliance on Section 4(a) (6) within the preceding 12-month period;<sup>121</sup>
- For Issuers offering \$100,000 or less, financial statements certified by the principal executive officer to be true and complete in all material respects. For Issuers offering more than \$100,000 but not more than \$500,000, provide financial statements reviewed by a public accountant that is independent of the Issuer; and For Issuers offering more than \$ 500,000 but not more than \$ 1 million of securities, provide financial statements reviewed by a public accountant that is independent of the Issuer;<sup>122</sup>
- Issuer posts the annual report on its website.<sup>123</sup>

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118 See 17 C.F.R. § 227.201(r). (Also see instruction to the rule on definition of what a "transaction" includes, which is consistent with Item 404 of Regulation S-K. Limited to transactions occurring since the beginning of the Issuer's last fiscal year and are in excess of five percent of the aggregate amount of capital raised by the issuer in reliance on Section 4(a)(6).)

119 See 17 C.F.R. § 227.201(y).

120 See 17 C.F.R. § 227.201(s). (Instruction on description moved from proposed Rule 201(t) to Rule 201(s).)

121 See 17 C.F.R. § 227.201(t).

122 See 17 C.F.R. § 227.201(t)(1),(2) and (3).

123 See 17 C.F.R. § 227.202(a).



## **EXHIBIT 2**

### **Filing and Termination Requirements required by the SEC**

- Progress Update Requirement (Issuers can satisfy the progress update requirement by relying on the relevant intermediary to make publicly available on the intermediary's platform frequent updates about the Issuer's progress. Otherwise, Issuer would need to file interim progress updates);<sup>124</sup>
- A Form C-U to report the total amount of the securities sold in the offering;<sup>125</sup>
- A Form C-A to amend disclosures previously made;<sup>126</sup>
- For any change, additional or update constitutes a material change to information previously disclosed, the Issuer must check the box on the cover of Form C indicating that investors must reconfirm their investment commitments;<sup>127</sup>
- For Issuers that sold securities in reliance on Section 4(a)(6), file an annual report with the SEC, no later than 120 days after the end of the fiscal year covered by the report. The annual report would disclose information about the Issuer and its financial condition, as required in connection with the offer and sale of the securities;<sup>128</sup>
- Under the statute and the final rules, the securities will be freely tradable after one year.

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<sup>124</sup> See 17 C.F.R. § 227.201(v) and .203(a)(3).

<sup>125</sup> See 17 C.F.R. § 227.201(a)(3)(ii).

<sup>126</sup> See 17 C.F.R. § 227.201(a)(2) of Regulation Crowdfunding.

<sup>127</sup> 17 C.F.R. § 227.201(a)(2) of Regulation Crowdfunding.

<sup>128</sup> See 17 C.F.R. § 227.202(a).

**Exhibit 3**

**Equity Crowdfunding Estimated Costs for Issuers (Rounded)<sup>129</sup>**

<b>Costs and Burdens for Offerings under Section 4(a)(6) (Issuer Costs)</b>	<b>Amount in Dollars</b>
Offerings of \$100,000 or less	\$5,000 - \$15,000 5% - 15%
Offerings of more than \$100,000, but not more than \$ 500,000	\$10,000 - \$50,000 5% - 10%
Offerings of more than \$500,000 - \$1,000,000	\$25,000 - \$75,000 5% - 7.5%

**Issuer Burdens:**

- File Disclosures on Offer Date and Annual Basis Thereafter;
- Audited Financial Statements for offerings more than \$500,000;
- Issuer Filing Requirements;
- Financials Reviewed in Accordance with SSARS issued by the Issuers;
- Mandated Disclosures filed on EDGAR using new Form C and Form C-AR: Annual Report;
- Prohibition on Advertising Terms of Offering;
- Prohibitions on Promoters receiving Compensation;
- Restriction on Resales for One Year.

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129 SEC, CROWDFUNDING 497-98 (2015), <https://www.sec.gov/rules/final/2015/33-9974.pdf>.

**EXHIBIT 4(A)**

**Equity Crowdfunding Estimated Costs for Intermediaries That Register as Broker Dealers<sup>130</sup>**

<b>New Broker Dealer Costs</b>	<b>Estimated Costs</b>	
	Initial Cost (Year 1)	Ongoing Cost Per Year
Form BD Registration and National Securities Association Membership	\$27,000	\$50,000
Complying with Requirements to Act as Intermediary in, and to Engage in Broker- Dealer Activities Related to, Transactions pursuant to Section 4(a)(6)	\$245,000	\$180,000
Platform Development	\$425,000	\$85,000
Subtotal	\$945,000	\$315,000

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130 Id. at 445. The SEC also noted that the costs to develop a platform are expected to vary depending on the extent to which the entity already has a platform and related systems in place. The costs include, among others, the costs to the broker-dealer of having associated persons who have licensing requirements, suitability requirements, requirements relating to advertisements, net capital requirements, and compliance with Exchange Act Rule 15c2-4 (17 CFR 240.15c2-4), as well as the costs of complying with Subpart C of Regulation Crowdfunding.

**EXHIBIT 4(B)**

**Equity Crowdfunding Estimated Costs for Intermediaries That Register as Funding Portals<sup>131</sup>**

<b>New Funding Portal Costs</b>	<b>Estimated Costs</b>	
	Initial Cost (Year 1)	Ongoing Cost Per Year
Form Funding Portal Registration and National Securities Association	\$100,000	\$10,000
Complying with Requirements to Act as Intermediary in Transactions pursuant to Section 4(a)(6)	\$67,000	\$40,000
Platform Development	\$425,000	\$85,000
Subtotal	\$592,000	\$135,000

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<sup>131</sup> Id. at 446 (The SEC noted that the costs include complying with Subparts C and D of Regulation Crowdfunding).

**EXHIBIT 4(C)****Estimated Incremental Costs of Intermediaries Already Registered as Brokers<sup>132</sup>**

<b>Broker-Dealers Already Registered Costs</b>	<b>Estimated Costs</b>	
	Initial Cost (Year 1)	Ongoing Cost Per Year
Form BD Registration and National Securities Association Membership	N/A (Already Registered)	(Already Registered)
Complying with Requirements to Act as Intermediary in and to Engage in Broker Activities Related to Sec. 4(a)(6)	\$45,000	\$30,000
Platform Development	\$425,000	\$85,000
Subtotal	\$470,000	\$115,000

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<sup>132</sup> *Id.*

**EXHIBIT 5**

**Equity Crowdfunding Estimated Costs for Investors<sup>133</sup>**

Investor Costs	Estimates [Update]
Cost of Capital Investment Pledged	\$1 to \$100,000
Due Diligence	\$1,500 to \$10,000 (Audits)
Loss of 5% - 15% equity in the transaction	Compliance Costs for Issuers passed through from Intermediaries
Passing a Financial Literacy Test	TBD

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133 *Id.*